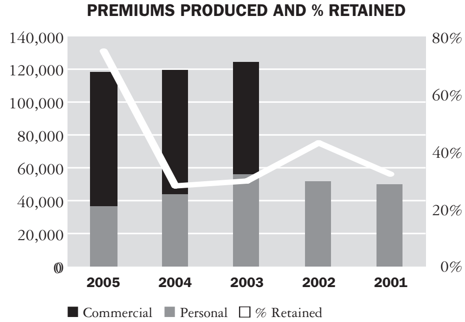
HALLMARK
FINANCIAL
SERVICES, INC.

2005 Annual Report

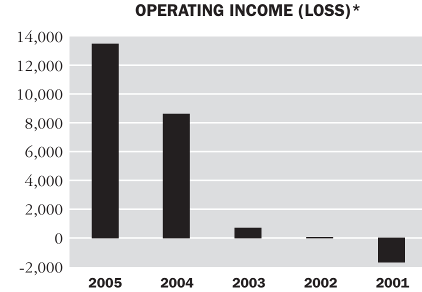
FINANCIAL HIGHLIGHTS

(Dollars in thousands, except per share amounts)	For the Years Ended December 31, 2005	2004	2003	2002	2001
OPERATING RESULTS					
Gross premiums produced	$118,066	$119,305	$124,264	$51,643	$49,614
Net premiums earned	$ 59,184	$ 32,445	$ 41,975	$20,213	$16,376
Operating income (loss)*	$ 13,468	$ 8,602	$ 686	$ 36	$ (1,674)
Net income (loss)	$ 9,186	$ 5,849	$ 8,745	$ (1,671)	$ (1,130)
Weighted average shares outstanding – diluted	72,626	42,781	29,559	20,329	20,251
PER SHARE					
Net income (loss) – diluted	$ 0.13	$ 0.14	$ 0.30	$ (0.08)	$ (0.06)
Book value	$ 0.98	$ 0.90	$ 0.75	$ 0.77	$ 0.94
SELECTED BALANCE SHEET ITEMS					
Total investments	$ 95,044	$ 32,121	$ 29,855	$16,728	$16,223
Total assets	$208,906	$ 82,511	$ 83,853	$83,761	$73,605
Unpaid loss and loss adjustment expenses	$ 26,321	$ 19,648	$ 28,456	$17,667	$20,089
Unearned premiums	$ 36,027	$ 6,192	$ 5,862	$15,957	$16,793
Total liabilities	$123,718	$ 49,855	$ 56,456	$75,226	$63,237
Total stockholders' equity	$ 85,188	$ 32,656	$ 27,397	$ 8,535	$10,368
Return on beginning equity (excluding extraordinary gains)	28.1%	21.3%	7.7%	-16.1%	-9.8%
STATUTORY RATIOS					
Loss ratio	60.3%	60.4%	72.5%	76.8%	98.6%
Expense ratio	32.8%	28.3%	28.6%	19.5%	16.7%
Combined ratio	93.1%	88.7%	101.1%	96.3%	115.3%

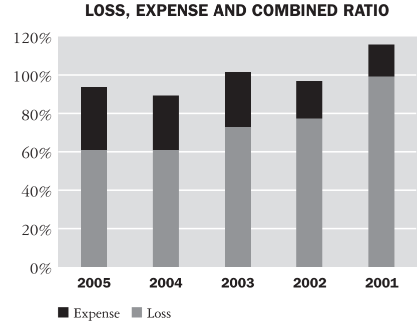
PREMIUMS PRODUCED AND % RETAINED



OPERATING INCOME (LOSS)*

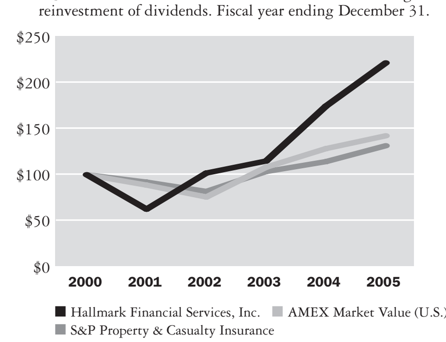


LOSS, EXPENSE AND COMBINED RATIO



COMPARISON OF 5-YEAR CUMULATIVE TOTAL RETURN

$100 invested on 12/31/00 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.



**Operating income (loss) is income (loss) before income tax, cumulative effect of change in accounting principle and extraordinary gains.*

TO OUR SHAREHOLDERS

Fiscal 2005 proved to be another year of milestones for Hallmark. Profitability reached a record high of $13.5 million in pre-tax operating income, a 57% increase over last year and the fourth consecutive improvement in year-over-year results. This result again reflects improved contributions from both our Commercial and Personal Insurance Operations, as well as increased investment income.

In our Commercial Insurance Operation pre-tax operating income more than doubled over 2004 results. In-force policy counts increased 4.4% and average premium per policy increased 4.9%. Retention rates on renewals remained very strong and operating expenses and loss results remained steady. During the year, we also successfully completed a major strategic objective of our Commercial Insurance Operation. Beginning in the third quarter, this Operation began retaining the premiums it produces through American Hallmark Insurance Company. This objective was accomplished through the completion of a $45 million common stock rights offering and the issuance of $30 million of trust preferred securities. The funds raised were contributed to our insurance subsidiaries and resulted in upgrades to the A.M. Best ratings of these entities, with American Hallmark Insurance Company receiving an "A-" and Phoenix Indemnity Insurance Company receiving a "B+".

In our Personal Insurance Operation, pre-tax operating profit increased 44% over 2004 results. In a very competitive marketplace our focus remained on maintaining underwriting discipline and controlling expenses. This Operation produced a combined ratio of 86%, the best underwriting performance in our Company's history. On the operational front, solid core business has been maintained and the foundation for future growth has begun with branding initiatives, development of new products and expanding our licenses into new states.

During 2005, we also announced definitive agreements to acquire two separate insurance operations that will further increase the scope of our Company's operations. The first announced acquisition was Texas General Agency, Inc. ("TGA") and certain wholly-owned affiliates including Gulf States Insurance Company. TGA is a managing general agency involved in the marketing and servicing of property and casualty insurance products, with a particular emphasis on commercial automobile and general liability risks. The second announced acquisition was Aerospace Holdings, LLC ("Aerospace") and various wholly-owned subsidiaries, including Aerospace Insurance Managers, Inc., that market and service general aviation property and casualty insurance products. Aerospace is one of the premier underwriters in this market and ranks among the top 10 largest producers of general aviation insurance in the United States.

While each of the transactions is very different from one another, they share the common characteristics of being established businesses that possess specialized underwriting expertise and have long-standing records of consistent profitability. In both cases, Hallmark is providing succession solutions for family-owned businesses, but current management will remain in place and continue to run the operations. Each transaction also possesses the same compelling business proposition for Hallmark. Hallmark will enhance the utilization of its existing capital and "A-" rating to support the retention of these books of business, recapturing substantial profits that are currently shared with third parties. We warmly welcome the owners and employees of these businesses to the Hallmark family of companies and look forward to sharing in their future success.

Mark E. Schwarz
Chairman and Chief Executive Officer

April 7, 2006

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

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended **DECEMBER 31, 2005**

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	**87-0447375**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
777 Main Street, Suite 1000, Fort Worth, Texas	**76102**
(Address of Principal Executive Offices)	(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock $.03 par value	**American Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes__ No_X_

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes__ No_X_

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 _X_ 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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer __ Accelerated filer __ Non-accelerated filer X

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes __ No X

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. $22,359,299

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. Common stock, $.03 par value 86,884,647 shares outstanding as of March 15, 2006.

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.

Glossary of Terms

For convenient reference, the acronyms and other defined terms used in the text of this report and the notes to our consolidated financial statements have the following meanings:

- “2005 LTIP” means our 2005 Long Term Incentive Plan.
- “Aerospace” means Aerospace Holdings, LLC.
- “AHGA” means American Hallmark General Agency Inc.
- “AHIC” means American Hallmark Insurance Company of Texas.
- “APB” means Accounting Principles Board.
- “APB 25” means APB Opinion No. 25, “Accounting for Stock Issued to Employees.”
- “AZDOI” means Arizona Department of Insurance.
- “Clarendon” means Clarendon National Insurance Company.
- “Director Plan” means our 1994 Non-Employee Director Stock Option Plan.
- “Dorinco” means Dorinco Reinsurance Company.
- “ECM” means Effective Claims Management, Inc.
- “Employee Plan” means our 1994 Key Employee Long Term Incentive Plan.
- “FASB” means Financial Accounting Standards Board.
- “GAAP” means U.S. generally accepted accounting principles.
- “Hallmark” means Hallmark Financial Services, Inc.
- “HFC” means Hallmark Finance Corporation.
- “HGA” means Hallmark General Agency, Inc.
- “LAE” means loss adjustment expense.
- “Millers” means Millers American Group, Inc.
- “NAIC” means National Association of Insurance Commissioners.
- “Newcastle” means Newcastle Partners, L.P.
- “OACM” means Old American County Mutual Fire Insurance Company.
- “Opportunity Funds” means Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P.
- “PGA” means Phoenix General Agency.
- “PIIC” means Phoenix Indemnity Insurance Company.
- “RBC” means risk-based capital.
- "SAP" means statutory accounting practices.

- "SFAS 123" means FASB Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation."
- "SFAS 123R" means FASB Statement of Financial Accounting Standards No. 123R, "Share Based Payment."
- "SFAS 128" means FASB Statement of Financial Accounting Standards No. 128, "Earnings Per Share."
- "SFAS 141" means FASB Statement of Financial Accounting Standards No. 141, "Business Combinations."
- "SFAS 142" means FASB Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets."
- "SFAS 148" means FASB Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure."
- "State & County" means State & County Mutual Fire Insurance Company.
- "TDI" means Texas Department of Insurance.
- "TGA" means Texas General Agency, Inc. and certain affiliated companies.
- "We," "us" and "our" means Hallmark and its subsidiaries.

PART I

Item 1. Business.

Introduction

Hallmark Financial Services, Inc., ("Hallmark" and, together with subsidiaries, "we", "us", "our") is an insurance holding company engaged in the sale of property and casualty insurance products to businesses and individuals. Hallmark was formed in 1987 and commenced its insurance operations in 1990. Our business involves marketing and underwriting commercial insurance in Texas, New Mexico, Idaho, Oregon, Montana and Washington; marketing and underwriting non-standard personal automobile insurance in Texas, New Mexico and Arizona; marketing of general aviation insurance in 44 states (effective January 1, 2006); claims administration; and other insurance related services. We have pursued our business activities through subsidiaries whose operations are organized into our Commercial Insurance Operation segment, which handles commercial insurance products and services, and our Personal Insurance Operation segment, which handles non-standard personal automobile insurance products and services. We expect to realign our operational segments during 2006 to reflect the activities of newly acquired subsidiaries. (See, "Item 1. Business – Recent Events.")

Recent Events

During the second quarter of 2005, we successfully completed a capital plan which raised $45 million through a shareholder rights offering and $30 million through a private placement of trust preferred securities. Upon completion of these capital enhancements, A.M. Best upgraded the financial strength ratings of Hallmark's two insurance carrier subsidiaries. The financial strength rating of American Hallmark Insurance Company of Texas ("AHIC") improved to A- (excellent) from B (fair) and the financial strength rating of Phoenix Indemnity Insurance Company ("PIIC") improved to B+ (very good) from B- (fair).

On November 14, 2005, we announced the signing of a definitive purchase agreement to acquire Texas General Agency, Inc ("TGA"). This transaction was closed effective January 1, 2006. TGA is a managing general agency involved in the marketing, underwriting and servicing of property and casualty insurance products, with a particular emphasis on commercial automobile and general liability risks. The acquisition also included TGA's wholly-owned insurance subsidiary, Gulf States Insurance Company, which reinsures a portion of the business written by TGA, as well as TGA Special Risk, Inc., which brokers mobile home insurance, and Pan American Acceptance Corporation, which engages in financing premiums on property and casualty insurance products marketed by TGA and TGA Special Risk, Inc. The acquisition of TGA is expected to significantly expand the scope of Hallmark's insurance marketing operations and provide opportunities for increased underwriting by our Commercial Insurance Operation.

On December 13, 2005, we announced the signing of a definitive agreement to acquire Aerospace Holdings, LLC ("Aerospace"). This transaction was also closed effective January 1, 2006. Aerospace, through various wholly owned subsidiaries, including Aerospace Insurance Managers, Inc., is involved in the marketing and servicing of general aviation property and casualty insurance products with a particular emphasis on private and small commercial aircraft. With the acquisition of Aerospace, Hallmark entered the general aviation market as part of our continuing strategy to expand into specialty lines businesses.

We funded the acquisition of Aerospace by borrowing $12.5 million from Newcastle Partners, L.P. on January 3, 2006. We funded the cash required to close the acquisitions of TGA by borrowing $15.0 million under our revolving credit facility with Frost National Bank on January 30, 2006. On January 27, 2006, we also issued an aggregate of $25.0 million in subordinated convertible promissory notes to Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. (collectively, "Opportunity Funds"), the proceeds of which were used to establish a trust account securing payment of future installments in connection with the TGA acquisition. (See, "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources – Credit facility" and "— Other debt obligations.")

Commercial Insurance Operation

Our Commercial Insurance Operation markets and underwrites commercial insurance policies through approximately 170 independent agencies operating primarily in the non-urban areas of Texas, New Mexico, Idaho, Oregon, Montana and Washington. During 2005, the members of the Commercial Insurance Operation included a regional managing general agency, Hallmark General Agency, Inc. ("HGA"), and a claims administration company, Effective Claims Management, Inc. ("ECM"). HGA has historically maintained excellent relationships with its producing agents. During fiscal 2005, the top 10 independent agency groups produced 35%, and no individual agency group produced more than 8%, of the total premium volume of our Commercial Insurance Operation. HGA targets customers that are in the low hazard classifications in the standard commercial market, which as a group have relatively stable loss results. The typical HGA customer is a small to medium sized business with a policy that covers property, general liability and auto exposures. The HGA 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. ECM administers the claims on the insurance policies produced by HGA. Products offered by HGA include the following:

- **Commercial Auto** – provides third party bodily injury and property damage coverage and first party property damage coverage against losses resulting from the ownership, maintenance or use of automobiles and trucks in connection with an insured's business.
- **General Liability** – provides coverage for third party bodily injury and property damage claims arising from accidents occurring on the insured's premises or from their general business operations.
- **Umbrella** – provides coverage for third party liability claims where the loss amount exceeds coverage limits provided by the insured's underlying general liability and commercial auto policies.
- **Commercial Property** – provides first party coverage for the insured's real property, business personal property, and business interruption losses caused by fire, wind, hail, water damage, theft, vandalism and other insured perils.
- **Commercial Multi-Peril** – provides a combination of property and liability coverage that can include commercial auto coverage on a single policy.
- **Business Owner's Policy** – provides a package of coverage designed for small to medium sized businesses with homogeneous risk profiles. Coverage includes general liability, commercial property and commercial auto.

HGA writes most risks on a package basis using a commercial multi-peril policy or a business owner's policy. Umbrella policies are written only when HGA also writes the insured's underlying general liability and commercial auto coverage. Through December 31, 2005, HGA marketed policies on behalf of Clarendon National Insurance Company ("Clarendon"), a third party insurer. On July 1, 2005, HGA began marketing new policies for AHIC. Beginning in 2006, HGA will market new and renewal policies only for AHIC. HGA earns a commission based on a percentage of the earned premium it produces. The commission percentage is determined by the underwriting results of the policies produced. ECM receives a claim servicing fee based on a percentage of the earned premium produced, with a portion deferred for casualty claims.

All of our commercial policies are for a term of twelve months. If the insured is unable or unwilling to pay for the entire premium up front, we provide an installment payment plan that allows the insured to pay 20% down and the remaining payments over eight months. The terms of this plan were changed in the first quarter of 2004. The prior plan allowed the insured to pay 30% down and the remaining payments over six months. We charge a flat $7.50 installment fee per payment for the installment payment plan. We recognized $0.4 million, $0.3 million and $0.1 million in Commercial Insurance Operation installment fee revenue in 2005, 2004 and 2003, respectively.

Personal Insurance Operation

Our Personal Insurance Operation markets minimum limits non-standard automobile policies through approximately 760 independent agents in Texas, New Mexico and Arizona. We conduct this business under the name Phoenix General Agency ("PGA"). PGA provides management, policy and claims services to PIIC and includes the operations of American Hallmark General Agency Inc. ("AHGA") and Hallmark Claims Services, Inc. During fiscal 2005, the top 10 independent agency groups produced 26%, and no individual agency group produced more than 4%, of the total premium volume of the Personal Insurance Operation. Our non-standard automobile insurance provides for the minimum limits of liability coverage mandated by state laws to drivers who find it difficult to purchase automobile insurance from standard carriers as a result of various factors, including driving record, vehicle, age, claims history, or limited financial resources. Products offered by PGA include the following:

- **Personal Auto Liability** – provides coverage for automobile liability exposures including bodily injury and property damage arising from accidents involving the insured.
- **Personal Auto Physical Damage** – provides collision and comprehensive coverage for physical damage exposure to the insured vehicle as a result of an accident with another vehicle or object, or as a result of causes other than collision such as vandalism, theft, wind, hail or water.

PGA currently offers one, two, three, six and twelve month policies. Net premium volume was composed of a policy mix of 46.2% monthly and 53.8% six-month policies in 2005; 51.8% monthly and 48.2% six-month policies in 2004; and 6.2% annual, 43.6% monthly and 50.2% six-month policies in 2003.

Our typical non-standard auto customer is unable or unwilling to pay a full or half year's premium in advance. Accordingly, we currently offer a direct bill program where the premiums are directly billed to the insured on a monthly basis. We charge an installment fee between $3.00 and $9.00 per payment under the direct bill program. We recognized $1.6 million, $1.8 million, and $1.6 million in Personal Insurance Operation installment fee revenue in 2005, 2004 and 2003, respectively. Prior to July 2003, we offered premium financing for annual policies.

PGA markets our non-standard auto policies in Arizona and New Mexico directly for PIIC. PGA currently provides non-standard auto insurance in Texas 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, we provided non-standard auto insurance in Texas through a reinsurance arrangement with another unaffiliated company, State & County Mutual Fire Insurance Company ("State & County"). PGA holds a managing general agency appointment from OACM to manage the sale and servicing of OACM policies. Effective October 1, 2004, AHIC reinsures 100% of the OACM policies produced by PGA under a related reinsurance agreement. Prior to October 1, 2004, AHIC reinsured 45% of the OACM policies produced by PGA. PGA began marketing an additional Texas non-standard auto insurance program directly for PIIC late in the fourth quarter of 2005.

Underwriting and Other Ratios

An insurance company's underwriting performance is traditionally measured by its statutory loss and loss adjustment expense ("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.

The following table shows, for each of the years in the three year period ended December 31, 2005, (i) our gross premiums written, and (ii) our underwriting results as measured by the net statutory loss and LAE ratio, the statutory expense ratio, and the statutory combined ratio for each calendar year.

	2005	2004	2003
Gross Premiums Written	$ 89,467	$ 33,389	$ 43,338
Statutory Loss & LAE Ratio	60.3%	60.4%	72.5%
Statutory Expense Ratio	32.8%	28.3%	28.6%
Statutory Combined Ratio	93.1%	88.7%	101.1%

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 U.S. generally accepted accounting principles ("GAAP"). The increase in the statutory expense ratio in 2005 was driven primarily by the assumption of commercial premium from Clarendon. The decrease in the statutory loss and LAE ratio from 2003 to 2004 was due largely to favorable loss development in prior accident years as well as the settlement of a PIIC bad faith claim in 2003.

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 2005, 2004, and 2003, AHIC's premium-to-surplus percentages were 94%, 122%, and 150%, respectively. Phoenix's premium-to-surplus percentages were 79%, 135% and 215% for 2005, 2004 and 2003, respectively. These declining premium-to-surplus percentages reflect added underwriting capacity attributable to the increased surplus from profitable operations and our 2005 capital plan. (See, "Item 1. Business – Recent Events.")

Reinsurance

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

For policies originated prior to April 1, 2003, we assumed the reinsurance of 100% of the Texas non-standard auto business produced by PGA and underwritten by State & County and retroceded 55% of the business to Dorinco Reinsurance Company ("Dorinco"). Under this arrangement, we remain obligated to policyholders in the event that Dorinco does not meet its obligations under the retrocession agreement. From April 1, 2003 through September 30, 2004, we assumed the reinsurance of 45% of the Texas non-standard automobile policies produced by PGA 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, we are obligated to policyholders only for the portion of the risk that we assumed. Effective October 1, 2004, we assume and retain the reinsurance of 100% of the Texas non-standard automobile policies produced by PGA and underwritten by OACM.

Under our prior insurance arrangements with Dorinco, we earned ceding commissions based on loss ratio experience on the portion of policies reinsured by Dorinco. We 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, 2005 and 2004, the accrued ceding commission payable to Dorinco was $0.4 million and $1.0 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):

	2005	2004	2003
Gross premiums written	$ 89,467	$ 33,389	$ 43,338
Ceded premiums written	(1,215)	(322)	(6,769)
Net premiums written	$ 88,252	$ 33,067	$ 36,569
Gross premiums earned	$ 59,632	$ 33,058	$ 57,447
Ceded premiums earned	(448)	(613)	(15,472)
Net premiums earned	$ 59,184	$ 32,445	$ 41,975
Reinsurance recoveries	$ (492)	$ 163	$ 11,071

The following table presents our reinsurance recoverable balance as of December 31, 2005 by reinsurer (in thousands):

Reinsurer	Reinsurance Recoverable	A.M. Best Rating of Reinsurer
Dorinco Reinsurance Company	$ 426	A- (Excellent)
GE Reinsurance Corporation	10	A (Excellent)
Platinum Underwriters Reinsurance, Inc.	8	A (Excellent)
Total Reinsurance Recoverable	$ 444	

For additional information concerning reinsurance, see Note 6 of notes to our consolidated financial statements.

Our Personal Insurance Operation presently retains 100% of the risk associated with all non-standard auto policies marketed by PGA. Our Commercial Insurance Operation currently purchases reinsurance for the following exposures:

- **Property Catastrophe** – Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our commercial property insurance lines. Catastrophes might include multiple claims and policyholders. Catastrophes include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Our property catastrophe reinsurance is excess-of-loss reinsurance, which provides us reinsurance coverage for losses in excess of an agreed-upon amount. We utilize catastrophe models to assist in determining appropriate retention and limits to purchase. The terms of our current property catastrophe reinsurance, effective October 1, 2005, are:
    - We retain the first $1 million of property catastrophe losses; and
    - Our reinsurers reimburse us 95% for each $1 of loss in excess of our $1 million retention up to $4.75 million for each catastrophic occurrence, subject to a two event maximum for the contractual term.
- **Commercial Property** – Our commercial property reinsurance reduces the financial impact a single-event or catastrophic loss may have on our results. It is excess-of-loss coverage. The terms of our current commercial property reinsurance, effective July 1, 2005, are:
    - We retain the first $500 thousand of loss for each commercial property risk;
    - Our reinsurers reimburse us for the next $4.5 million for each commercial property risk; and
    - Individual risk facultative reinsurance is purchased on any commercial property with limits above $5 million.

- **Commercial Umbrella** – Our commercial umbrella reinsurance reduces the financial impact of losses in this line of business. Our commercial umbrella reinsurance is quota-share reinsurance, in which the reinsurers share a proportional amount of the premiums and losses. Under our current commercial umbrella reinsurance, effective July 1, 2005, we retain 10% of the premiums and losses and cede 90% to our reinsurers.

- **Commercial Casualty** – Our commercial casualty reinsurance reduces the financial impact a single-event loss may have on our results. It is excess-of-loss coverage. The terms of our current commercial casualty reinsurance, effective July 1, 2005, are:

    - We retain the first $500 thousand of any commercial liability loss, including commercial automobile liability; and
    - Our reinsurers reimburse us for the next $500 thousand for each commercial liability loss, including commercial automobile liability.

Competition

The property and casualty insurance market, our 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 3,120 property and casualty insurance companies and 2,019 property and casualty insurance groups operating in North America as of July 22, 2005. Our Commercial Insurance Operation 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. Although our Personal Insurance Operation competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace our competition is most directly associated with numerous regional companies and managing general agencies. Our competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than we have.

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

The Commercial Insurance Operation experienced moderate rate pressure in 2005 after three years of double digit rate growth. However, because we focus the distribution of our commercial products in smaller non-urban markets that are less price sensitive, we were able to keep our overall rate levels relatively flat in 2005. We believe increased rate pressure will at least continue through 2006.

The Personal Lines Operation competes primarily in the minimum limits personal non-standard automobile market. Underwriters in this market segment maintained moderate pricing discipline during 2005, with a bias toward decreasing rates. We believe this rate pressure will continue at least through 2006.

Insurance Regulation

Our insurance operations are regulated by the TDI and AZDOI. AHIC and PIIC are required to file quarterly and annual statements of their financial condition with TDI and AZDOI, respectively, prepared in accordance with SAP. The financial conditions of AHIC and PIIC, including the adequacy of surplus, loss reserves and investments, are subject to review by TDI and AZDOI, respectively. We do not write our Texas non-standard automobile insurance directly, but assume 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. PGA is also subject to TDI licensing requirements. Our premium finance company, Hallmark Finance Corporation ("HFC"), is subject to licensing, financial reporting and certain financial requirements imposed by TDI. HFC is also regulated by the Texas Office of Consumer Credit Commissioner. Since we discontinued writing annual premium financed policies in July 2003, HFC does not have any ongoing operations.

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.

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

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. AHIC's 2005, 2004 and 2003 adjusted capital under the RBC calculation exceeded the minimum requirement by 600%, 412% and 186%, respectively. PIIC's 2005, 2004 and 2003 adjusted capital under the RBC calculation exceeded the minimum requirement by 365%, 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. Claim adjusters employed by us are also subject to the licensing requirements of each state in which they conduct business. Each employed claim adjuster either holds or has applied for the required licenses.

Analysis of Losses and LAE

Our consolidated financial statements include an estimated reserve for unpaid losses and LAE. We estimate our reserve for unpaid losses and LAE by using case-basis evaluations and statistical projections, which include inferences from both losses paid and losses incurred. We also use recent historical cost data, periodic reviews of underwriting standards and claims management to modify the statistical projections. We give consideration to the impact of inflation in determining our loss reserves, but do not discount reserve balances.

The amount of reserves represents our estimate 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. We continually review the estimates and adjust 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. We seek to continually improve our loss estimation process by refining our 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 2005, 2004 and 2003 reconciliation of the beginning and ending reserve balances, on a gross-of-reinsurance basis, to the gross amounts reported in our balance sheet at December 31, 2005, 2004 and 2003 (in thousands):

	2005	2004	2003
Reserve for unpaid losses and LAE, net of reinsurance recoverables, January 1	$17,700	$21,197	$8,411
Acquisition of Phoenix January 1, 2003	-	-	10,338
Provision for losses and LAE for claims occurring in the current period	36,184	20,331	29,724
Increase (decrease) in reserve for unpaid losses and LAE for claims occurring in prior periods	(2,400)	(1,194)	464
Payments for losses and LAE, net of reinsurance:			
Current period	(17,414)	(10,417)	(21,895)
Prior periods	(8,073)	(12,217)	(5,845)
Reserve for unpaid losses and LAE at December 31, net of reinsurance recoverable	$25,997	$17,700	$21,197
Reinsurance recoverable on unpaid losses and LAE at December 31	324	1,948	7,259
Reserve for unpaid losses and LAE at December 31, gross of reinsurance	$26,321	$19,648	$28,456

The $2.4 million and $1.2 million favorable development in prior accident years recognized in 2005 and 2004, respectively, represent normal changes in actuarial estimates. 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 our 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 2005 and 2004 are summarized below (in thousands):

	December 31	
	2005	**2004**
Reserve for unpaid losses and LAE on a SAP basis (net of reinsurance recoverables on unpaid losses)	$24,580	$16,416
Loss reserve discount from the PIIC acquisition	(35)	(80)
Unamortized risk premium reserve discount from the PIIC acquisition	49	114
Estimated future unallocated LAE reserve for claim service subsidiaries	1,403	1,250
Reserve for unpaid losses and LAE on a GAAP basis (net of reinsurance recoverables on unpaid losses)	$25,997	$17,700

Analysis of Loss and LAE Reserve Development

The following table shows the development of our loss reserves, net of reinsurance, for 1995 through 2005. 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 us. 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.

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ANALYSIS OF LOSS AND LAE DEVELOPMENT
(Thousands of dollars)

Year Ended December 31	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
A. Reserve for Unpaid Losses & LAE, Net of Reinsurance Recoverables	$5,923	$5,096	$4,668	$4,580	$5,409	$7,451	$7,919	$8,411	$21,197	$17,700	$25,997
B. Net Reserve Re-estimated as of :											
One year later	5,910	6,227	4,985	4,594	5,506	7,974	8,096	8,875	20,003	15,300	
Two years later	6,086	6,162	4,954	4,464	5,277	7,863	8,620	8,881	19,065		
Three years later	6,050	6,117	4,884	4,225	5,216	7,773	8,856	8,508			
Four years later	6,024	6,070	4,757	4,179	5,095	7,901	8,860				
Five years later	6,099	5,954	4,732	4,111	5,028	7,997					
Six years later	6,044	5,928	4,687	4,101	5,153						
Seven years later	6,038	5,900	4,695	4,209							
Eight years later	6,029	5,902	4,675								
Nine years later	6,035	5,881									
Ten years later	6,035										
C. Net Cumulative Redundancy (Deficiency)	(112)	(785)	(7)	371	256	(546)	(941)	(97)	2,132	2,400	
D. Cumulative Amount of Claims Paid, Net of Reinsurance Recoveries, through:											
One year later	3,783	4,326	3,326	2,791	3,229	5,377	5,691	5,845	12,217	8,073	
Two years later	5,447	5,528	4,287	3,476	4,436	7,070	7,905	7,663	15,814		
Three years later	5,856	5,860	4,387	3,911	4,909	7,584	8,603	8,228			
Four years later	5,933	5,699	4,571	4,002	5,014	7,810	8,798				
Five years later	6,018	5,818	4,618	4,051	4,966	7,960					
Six years later	6,018	5,853	4,643	4,061	5,116						
Seven years later	6,029	5,860	4,664	4,204							
Eight years later	6,029	5,871	4,675								
Nine years later	6,035	5,881									
Ten years later	6,035										

	2004	2005
Net Reserve-December 31	$ 17,700	$ 25,997
Reinsurance Recoverables	1,948	324
Gross Reserve – December 31	$ 19,648	$ 26,321
Net Re-estimated Reserve	15,300	
Re-estimated Reinsurance Recoverable	2,246	
Gross Re-estimated Reserve	$ 17,546	
Gross Cumulative Redundancy	$ 2,102	

Investment Policy

Our investment objective is to maximize current yield while maintaining safety of capital together with sufficient liquidity for ongoing insurance operations. Our investment portfolio is composed of fixed income and equity securities. Our fixed income securities are made up of 62.4% corporate securities, 32.8% state and local securities, and 4.8% U.S. Government or U.S. Government agency securities. The average maturity of our fixed income portfolio as of December 31, 2005 was 5.2 years. The fair value of our fixed income securities as of December 31, 2005 was $87.3 million, of which $7.9 million is classified as restricted investments. If market rates were to change 1%, the fair value of our fixed income securities would change approximately $3.6 million as of December 31, 2005.

In addition, as part of our overall investment strategy, we maintain an integrated cash management system utilizing on-line banking services and daily overnight investment accounts to maximize investment earnings on all available cash. During 2005, our investment income totaled approximately $3.8 million compared to approximately $1.4 million for 2004. The increase in investment income in 2005 was due primarily to the infusion of $75 million in capital in the second quarter of 2005. For further discussion see *Liquidity and Capital Resources* in Item 7 of this Form 10-K.

Employees

On December 31, 2005, we employed 165 people on a full-time basis as compared to 179 people at December 31, 2004. None of our employees are represented by labor unions. We consider our employee relations to be excellent.

Item 1A. Risk Factors.

Our results may fluctuate as a result of cyclical changes in the property and casualty insurance industry.

All of our revenue is attributable to property and casualty insurance, which as an industry is cyclical in nature and has historically been characterized by soft markets followed by hard markets. A soft market is a period of relatively high levels of price competition, less restrictive underwriting standards and generally low premium rates. A hard market is a period of capital shortages resulting in lack of insurance availability, relatively low levels of competition, more selective underwriting of risks and relatively high premium rates.

Our industry is very competitive, which may unfavorably impact our results of operations.

The property and casualty insurance market, our 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 3,120 property and casualty insurance companies and 2,019 property and casualty insurance groups operating in North America as of July 22, 2005. Our Commercial Insurance Operation 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. Although our Personal Insurance Operation competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace our competition is most directly associated with numerous regional companies and managing general agencies. Our competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than we have.

Estimating reserves is inherently uncertain. If our loss reserves are not adequate, it will have an unfavorable impact on our results.

We maintain loss reserves to cover estimated liability for unpaid losses and LAE, for reported and unreported claims incurred as of the end of each accounting period. Reserves represent management's estimates of what the ultimate settlement and administration of claims will cost. These estimates, which generally involve actuarial projections, are based on management's assessment of facts and circumstances then known, as well as estimates of future trends in claim severity and frequency, judicial theories of liability, and other factors. These variables are affected by both internal and external events, such as changes in claim handling procedures, inflation, judicial trends and legislative changes. Many of these factors are not quantifiable. Additionally, there may be a significant reporting lag between the occurrence of an event and the time it is reported to us. The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to reserves are reflected in the results of the periods in which such estimates are changed. Because setting reserves is inherently uncertain, there can be no assurance that the current reserves will prove adequate.

Our results may be unfavorably impacted if we are unable to obtain adequate reinsurance.

If we are unable to obtain adequate reinsurance protection for the risks we have underwritten, we will either be exposed to greater losses from these risks or we will reduce the level of business that we underwrite, which will reduce our revenue. The amount, availability and cost of reinsurance are subject to prevailing market conditions beyond our control, and may affect our ability to write additional premiums as well as our profitability.

If the companies that provide our reinsurance do not pay all of our claims, we could incur severe losses.

We purchase reinsurance by transferring, or ceding, part of the risk we have assumed to a reinsurance company in exchange for part of the premium we receive in connection with the risk. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us of our liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. We cannot assure that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis.

Catastrophic losses may adversely affect our results of operations, liquidity and financial condition.

Property and casualty insurance companies are subject to claims arising out of catastrophes that may have a significant affect on their results of operations, liquidity and financial condition. Catastrophes can be caused by various events, including hurricanes, windstorms, earthquakes, hail storms, explosions, severe winter weather and fires, and may include man-made events, such as the September 11, 2001 terrorist attacks on the World Trade Center. The incidence, frequency, and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event.

We are subject to comprehensive regulation, and our results may be unfavorably impacted by these regulations.

We are subject to comprehensive governmental regulation and supervision. Most insurance regulations are designed to protect the interests of policyholders rather than of the stockholders and other investors of the insurance companies. These regulations, generally administered by the department of insurance in each state in which we do business, relate to, among other things;

- Approval of policy forms and rates,
- Standards of solvency, including risk based capital measurements (which are a measure developed by the National Association of Insurance Commissioners and used by the state insurance regulators to identify insurance companies that potentially are inadequately capitalized),
- Licensing of insurers and their agents,
- Restrictions on the nature, quality and concentration of investments,
- Restrictions on the ability of our insurance company subsidiaries to pay dividends,
- Restrictions on transactions between the insurance company subsidiaries and their affiliates,
- Requiring certain methods of accounting,
- Periodic examinations of operations and finances,
- Prescribing the form and content of records of financial condition to be filed, and
- Requiring reserves for unearned premium, losses and other purposes.

State insurance departments also conduct periodic examinations of the affairs of insurance companies and require filing of annual and other reports relating to the financial condition of insurance companies, holding company issues and other matters. Our business depends on compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Regulatory authorities may deny or revoke licenses for various reasons, including violations of regulations. Changes in the level of regulation of the insurance industry or changes in laws or regulations themselves or interpretations by regulatory authorities could have a material adverse affect on our operations.

State statutes limit the aggregate amount of dividends that our subsidiaries may pay Hallmark, thereby limiting its funds to pay expenses and dividends.

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company without significant operations of its own, Hallmark's principal sources of funds are dividends and other sources of funds from its subsidiaries. State insurance laws limit the ability of Hallmark's insurance company subsidiaries to pay dividends and require the insurance companies to maintain specified levels of statutory capital and surplus. These restrictions affect the ability of our insurance company subsidiaries to pay dividends and use their capital in other ways. Hallmark's right to participate in any distribution of assets of the insurance company subsidiaries is subject to prior claims of policyholders and creditors (except to the extent that its rights, if any, as a creditor are recognized). Consequently, Hallmark's ability to pay debts, expenses and cash dividends to our stockholders may be limited.

Our insurance company subsidiaries are subject to minimum capital and surplus requirements. Failure to meet these requirements could subject us to regulatory action.

Our insurance company subsidiaries are subject to minimum capital and surplus requirements imposed under the laws of Texas and Arizona. Any failure by one of our insurance company subsidiaries to meet minimum capital and surplus requirements imposed by applicable state law will subject it to corrective action, which may include requiring adoption of a comprehensive financial plan, revocation of its license to sell insurance products or placing the subsidiary under state regulatory control. Any new minimum capital and surplus requirements adopted in the future may require us to increase the capital and surplus of our insurance company subsidiaries, which we may not be able to do.

The loss of key executives could disrupt our business.

Our success will depend in part upon the continued service of certain key executives. Our success will also depend on our ability to attract and retain additional executives and personnel. The loss of key personnel could cause disruption in our business.

Adverse securities market conditions can have a significant and negative impact on our investment portfolio.

Our results of operations depend in part on the performance of our invested assets. As of December 31, 2005, 84.8% of our investment portfolio was invested in fixed maturity securities. Certain risks are inherent in connection with fixed maturity securities, including loss upon default and price volatility in reaction to changes in interest rates and general market factors. In general, the fair market value of a portfolio of fixed income securities increases or decreases inversely with changes in the market interest rates, while net investment income realized from future investments in fixed income securities increases or decreases along with interest rates. In addition, some of our fixed income securities have call or prepayment options. This could subject us to reinvestment risk should interest rates fall or issuers call their securities and we reinvest proceeds at lower interest rates. We attempt to mitigate this risk by investing in securities with varied maturity dates, so that only a portion of the portfolio will mature at any point in time. Furthermore, actual net investment income and/or cash flows from investments that carry prepayment risk (such as mortgage-backed and other asset-backed securities) may differ from those anticipated at the time of investment as a result of interest rate fluctuations. An investment has prepayment risk when there is a risk that cash flows from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. The fair value of our fixed income securities as of December 31, 2005 was $87.3 million. If market interest rates were to change 1%, (e.g. from 5% to 6%), the fair value of our fixed income securities would change approximately $3.6 million as of December 31, 2005. The change in fair value was determined using duration modeling assuming no prepayments.

In addition to the general risks described above, although we maintain an investment grade portfolio, our fixed income securities are also subject to credit risk. If any of the issuers of our fixed income securities suffer financial set backs, the ratings on the fixed income securities could fall (with a concurrent fall in market value) and, in a worst case scenario, the issuer could default on its obligations. Future changes in the fair market value of our available-for-sale securities will be reflected in other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our shareholders' equity, total comprehensive income and/or our cash flows.

We are reliant on independent agents to market our products and their failure to do so would have a material adverse effect on our results of operations.

We principally market our insurance programs through independent insurance agents. As a result, our business depends in large part on the marketing efforts of these agents and on our ability to offer insurance products and services that meet the requirements of the agents and their customers. The agents, however, are not obligated to sell or promote our products and many sell or promote competitors' insurance products in addition to our products. The failure or inability of insurance agents to market our insurance products successfully could have a material adverse impact on our business, financial condition and results of operations.

We may experience difficulty in integrating recent acquisitions into our operations.

We completed the acquisitions of both Aerospace and TGA during January, 2006. The successful integration of these newly acquired businesses into our operations will require, among other things, the retention and assimilation of their key management, sales and other personnel; the coordination of their lines of insurance products and services; the adaptation of their technology, information systems and other processes; and the retention and transition of their customers. Unexpected difficulties in integrating these acquisitions could result in increased expenses and the diversion of management time and resources. If we do not successfully integrate these acquired businesses into our operations, we may not realize the anticipated benefits of one or both of the acquisitions, which could have a material adverse impact on our financial condition and results of operations.

Mark E. Schwarz, our Chairman and Chief Executive Officer, through his affiliation with Newcastle Partners, L.P. and the Opportunity Funds, has the ability to exert significant influence over our operations and may have interests that differ from those of our other stockholders.

Newcastle Partners, L.P. ("Newcastle") beneficially owns approximately 78% of our common stock. In addition, the Opportunity Funds hold convertible promissory notes which, subject to shareholder approval and certain anti-dilution provisions, are convertible into approximately 19.5 million shares of our common stock. Mark E. Schwarz has sole investment and voting control over the shares beneficially owned by Newcastle and the Opportunity Funds and thus has the ability to exert significant influence over our policies and affairs, including the election of our board of directors and the approval of any action requiring stockholder vote. The interests of Mr. Schwarz, Newcastle and the Opportunity Funds may differ from the interests of our other stockholders in some respects. Therefore, Mr. Schwarz, Newcastle and the Opportunity Funds may take action adverse to our other stockholders.

If we are unable to raise additional capital or restructure our indebtedness to Newcastle, we may have difficulty satisfying current liquidity requirements.

We funded the acquisition of Aerospace by borrowing $12.5 million from Newcastle on January 3, 2006. The principal and accrued interest of this bridge loan are payable on demand at any time after June 30, 2006. We have previously announced our intention to retire this debt through a rights offering of our common stock to existing shareholders during 2006. However, if we are unable to complete the rights offering or restructure the payment schedule of the bridge loan, we may be unable to repay the bridge loan when demand is made. Any default under the bridge loan to Newcastle would also be an event of default under our primary secured credit facility and, therefore, could have a material adverse effect on our liquidity and operations.

If our shareholders do not approve the conversion of the convertible promissory notes issued to the Opportunity Funds, we may be unable to satisfy future liquidity requirements.

In connection with the acquisition of TGA, we issued $25.0 million in convertible promissory notes to the Opportunity Funds, the principal of which becomes due on July 27, 2007. If conversion is approved by our shareholders, these convertible notes will be automatically converted to shares of our common stock at their maturity to the extent not previously converted by the holders. Newcastle owns sufficient shares of our common stock to assure shareholder approval and has an agreement with the Opportunity Funds to vote its shares in favor of such approval. Nonetheless, if we do not obtain such shareholder approval, we may be unable to repay the convertible notes at maturity. Any default under the convertible notes would also be an event of default under our primary secured credit facility and, therefore, could have a material adverse effect on our liquidity and operations.

Conversion of the convertible promissory notes issued to the Opportunity Funds will dilute the percentage ownership of our other shareholders.

Subject to shareholder approval, the convertible notes issued to the Opportunity Funds will become convertible by the holders into approximately 19.5 million shares of our common stock (subject to certain anti-dilution provisions), and will be automatically converted to such common stock at their maturity in July, 2007. Upon such conversion, the proportionate voting and ownership interest of all other shareholders will be reduced and the percentage of our equity attributable to previously issued shares of our common stock will be diluted.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties.

Our corporate headquarters and Commercial Insurance Operation 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, we renegotiated our lease for a period of 97 months to expire June 30, 2011. The rent is currently $32,327 per month.

Our Personal Insurance Operation 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. We renegotiated our 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.

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

Item 4. Submission of Matters to a Vote of Security Holders.

During the fourth quarter of 2005, we did not submit any matter to a vote of our security holders.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market for Common Stock

Our common stock is traded on the American Stock Exchange under the symbol "HAF". The following table shows the high and low sales prices of our common stock on the AMEX for each quarter since January 1, 2004.

Period	*High Sale*	*Low Sale*
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	$ 1.60	$ 1.11
Second Quarter	1.50	0.95
Third Quarter	1.39	1.09
Fourth Quarter	1.37	1.05
2006		
First Quarter (through March 6, 2006)	$ 2.05	$ 1.36

As of February 28, 2006 there were approximately 156 shareholders of record of our common stock.

Dividends

We have never paid dividends on our Common Stock. The Board of Directors intends to continue this policy for the foreseeable future in order to retain earnings for development of our business.

Equity Compensation Plan Information

The following table provides information as of December 31, 2005, concerning our common stock that may subsequently be issued upon the exercise of incentive stock options and nonqualified stock options granted to our directors, officers and key employees:

Plan Category	Number of securities to be issued upon exercise of outstanding Options, warrants and Rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)]
	(a)	(b)	(c)
Equity compensation plans approved by security holders	1,416,500	$0.85	4,470,000
Equity compensation plans not approved by security holders[1]	100,000	$0.38	- 0 -
Total	1,516,500	$0.82	4,470,000

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

Issuer Repurchases

We did not repurchase any shares of our common stock during the fourth quarter of 2005.

Item 6. Selected Financial Data.

(In thousands, except per share amounts)

	2005	2004 [1]	2003 [1,2,3]	2002 [1,2,4]	2001 [1]
Gross premiums written	$ 89,467	$ 33,389	$ 43,338	$ 51,643	$ 49,614
Ceded premiums written	(1,215)	(322)	(6,769)	(29,611)	(33,822)
Net premiums written	88,252	33,067	36,569	22,032	15,792
Change in unearned premiums	(29,068)	(622)	5,406	(1,819)	584
Net premiums earned	59,184	32,445	41,975	20,213	16,376
Investment income, net of expenses	3,836	1,386	1,198	773	1,043
Realized gains (losses)	58	(27)	(88)	(5)	-
Finance charges	2,044	2,183	3,544	2,503	3,095
Commission and fees	16,703	21,100	17,544	1,108	-
Processing and service fees	5,183	6,003	4,900	921	1,120
Other income	27	31	486	284	368
Total revenues	87,035	63,121	69,559	25,797	22,002
Loss and loss adjustment expenses	33,784	19,137	30,188	15,302	15,878
Other operating costs and expenses	38,492	35,290	37,386	9,474	6,620
Interest expense	1,264	64	1,271	983	1,021
Amortization of intangible assets	27	28	28	2	157
Total expenses	73,567	54,519	68,873	25,761	23,676
Income (loss) before income tax, cumulative effect of change in accounting principle and extraordinary gain	13,468	8,602	686	36	(1,674)
Income tax expense (benefit)	4,282	2,753	25	13	(544)
Income (loss) before cumulative effect of change in accounting principle and extraordinary gain	9,186	5,849	661	23	(1,130)
Cumulative effect of change in accounting principle, net of tax	-	-	-	(1,694)	-
Extraordinary gain	-	-	8,084	-	-
Net income (loss)	$ 9,186	$ 5,849	$ 8,745	$ (1,671)	$ (1,130)
Basic earnings (loss) per share:					
Income before cumulative effect of change in accounting principle and extraordinary gain	$0.13	$0.14	$0.02	-	($0.06)
Cumulative effect of change in accounting principle	-	-	-	(0.08)	-
Extraordinary gain	-	-	0.28	-	-
Net income (loss)	$0.13	$0.14	$0.30	($0.08)	($0.06)
Diluted earnings (loss) per share:					
Income before cumulative effect of change in accounting principle and extraordinary gain	$0.13	$0.14	$0.02	-	($0.06)
Cumulative effect of change in accounting principle	-	-	-	(0.08)	-
Extraordinary gain	-	-	0.28	-	-
Net income (loss)	$0.13	$0.14	$0.30	($0.08)	($0.06)

Item 6. Selected Financial Data (Cont.)

	2005	2004 [1]	2003 [1,2,3]	2002 [1,2,4]	2001 [1]
Balance Sheet Items:					
Total investments	$ 95,044	$ 32,121	$ 29,855	$ 16,728	$ 16,223
Total assets	$208,906	$ 82,511	$ 83,853	$ 83,761	$ 73,605
Unpaid loss and loss adjustment expenses	$ 26,321	$ 19,648	$ 28,456	$ 17,667	$ 20,089
Unearned premiums	$ 36,027	$ 6,192	$ 5,862	$ 15,957	$ 16,793
Total liabilities	$123,718	$ 49,855	$ 56,456	$ 75,226	$ 63,237
Total stockholders' equity	$ 85,188	$ 32,656	$ 27,397	$ 8,535	$ 10,368
Book value per share	$0.98	$0.90	$0.75	$0.77	$0.94

Notes:

1) In accordance with Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 128 "Earnings Per Share" ("SFAS 128"), we have restated the basic and diluted weighted average shares outstanding for the years 2004 and prior for the effect of a bonus element from our stockholder rights offerings that were successfully completed in 2005 and 2003. According to SFAS 128, there is an assumed bonus element in a rights issue whose exercise price is less than market value of the stock at the close of the rights offering period. This bonus element is treated as a stock dividend for reporting earnings per share.
2) The acquisitions of HGA, ECM and PIIC were financed through an $8.6 million loan from a related party that was repaid from $10 million of proceeds from a rights offering in 2003.
3) In January 2003, we acquired PIIC in satisfaction of $7.0 million of a $14.85 million balance on a note receivable due from Millers American Group, Inc. ("Millers"). This resulted in us recognizing an $8.1 million extraordinary gain in 2003.
4) In 2002, we adopted FASB Statement of Financial Accounting Standards, No. 142 "Goodwill and Other Intangible Assets" ("SFAS 142"), which prohibits amortization of goodwill and requires annual testing of goodwill for impairment. In the year of adoption, we 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, we acquired HGA and ECM from Millers.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included in this report.

Management Overview

Our business involves marketing and underwriting commercial insurance in Texas, New Mexico, Idaho, Oregon, Montana and Washington; marketing and underwriting non-standard personal automobile insurance in Texas, New Mexico and Arizona; marketing of general aviation insurance in 44 states (effective January 1, 2006); claims administration; and other insurance related services. We have pursued our business activities through subsidiaries whose operations are organized into our Commercial Insurance Operation segment, which handles commercial insurance products and services, and our Personal Insurance Operation segment, which handles non-standard personal automobile insurance products and services. We expect to realign our operational segments during 2006 to reflect the activities of newly acquired subsidiaries. (See, "Item 1. Business – Recent Events.")

For the year ended December 31, 2005, we reported net income of $9.2 million, representing a 57.1% increase over the $5.8 million reported for the prior year. On a diluted per share basis, net income was $0.13 for the year ended December 31, 2005, compared with net income of $0.14 per diluted share in 2004. The decrease in net income per diluted share was primarily attributable to an increase in the weighted average shares outstanding to 72.6 million diluted shares during 2005, compared to 42.8 million diluted shares during 2004, primarily as a result of a successful stockholder rights offering completed in the second quarter of 2005. In accordance with SFAS 128, we have restated the basic and diluted weighted average shares outstanding for 2004 and prior years for the effect of a bonus element from our stockholder rights offerings that were successfully completed in 2005 and 2003. According to SFAS 128, there is an assumed bonus element in a rights issue whose exercise price is less than the market value of the stock at the close of the rights offering period. This bonus element is treated as a stock dividend for reporting earnings per share.

The increase in earnings in 2005 reflects increased investment income attributable to additional capital raised from our shareholder rights offering and issuance of trust preferred securities in the second quarter of 2005. The improvement in 2005 earnings also reflects additional profit sharing commission revenue in the Commercial Insurance Operation due to favorable loss development in prior accident years, as well as improved loss experience on prior accident years in the Personal Insurance Operation.

Critical Accounting Estimates and Judgments

The significant accounting policies requiring our 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, we believe the estimates and judgments associated with the reported consolidated financial statement amounts are appropriate in the circumstances. For additional discussion of our accounting policies, see Note 1 to the consolidated financial statements included in this report.

Investments. We complete a detailed analysis each quarter to assess whether any 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 significantly 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 our 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. We routinely evaluate the realizability of deferred policy acquisition costs. At December 31, 2005 and 2004, there was no premium deficiency related to deferred policy acquisition costs.

Goodwill. Our consolidated balance sheet as of December 31, 2005 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, which we adopted as of January 1, 2002, goodwill is tested for impairment annually. We completed our annual test for impairment during the fourth quarter of 2005 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 our reporting units. As required by SFAS 142, we compare the estimated fair value of each reporting unit with its carrying amount, including goodwill. Under SFAS 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. We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes. A valuation allowance is provided against our deferred tax asset to the extent that we do 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, 2005 and 2004. 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 PIIC acquisition.

Reserves for Unpaid Losses and Loss Adjustment Expenses. Reserves for unpaid losses and LAE are established for claims which have already been incurred by the policyholder but which we have not yet paid. Losses and LAE represent the estimated ultimate net cost of all reported and unreported losses incurred through December 31, 2005 and 2004. 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 Losses and LAE" and "-Analysis of Loss and LAE Reserve Development.")

Although considerable variability is inherent in such estimates, we believe 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, 2005 unpaid losses and LAE would produce a $263 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 our actuary as of December 31, 2005 was $17.8 million to $31.5 million. Our best estimate of unpaid losses and LAE as of December 31, 2005 is $26.3 million. Our carried reserve for unpaid losses and LAE as of December 31, 2005 is comprised of $14.5 million in case reserves and $11.8 million in incurred but not reported reserves. In setting this estimate of unpaid losses and LAE, we have 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, we have established a best estimate of unpaid losses and LAE which is approximately $1.7 million higher than the midpoint of the actuarial range. It would be expected that management's best estimate would move within the actuarial range from year to year due to changes in our operations and changes within the marketplace.

The actuarial range is determined independently of management's best estimate and is only used to check the reasonableness of that estimate. There is no set method for determining ranges, and judgment enters into the process. The range was estimated primarily by measuring the variability of loss development patterns over time within each line of business. The results generated by multiple methods were also considered when determining the overall range. In light of the inherent uncertainty in reserve estimates, there can be no assurance that the actual losses ultimately experienced will fall within the actuarial range. However, in light of the breadth of the actuarial range, we believe that it is reasonably likely that actual losses will fall within such range.

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

Ceding Commissions of the Personal Insurance Operation. Under our reinsurance arrangements with Dorinco prior to October 1, 2004, we earn 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. We 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 12/31/05	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 Insurance Operation. Profit sharing commission of the Commercial Insurance Operation is calculated and recognized when the loss ratio, as determined by a qualified actuary, deviates from contractual targets. We receive a provisional commission as policies are produced as an advance against the later determination of the profit sharing commission actually earned. The profit sharing commission is an estimate that varies with the estimated loss ratio and is sensitive to changes in that estimate. The following table details the profit sharing commission revenue sensitivity to the actual ultimate loss ratio for each effective quota share treaty at 0.5% above and below the provisional loss ratio.

	Treaty Effective Dates			
	7/1/01	7/1/02	7/1/03	7/1/04
Provisional loss ratio	60.0%	59.0%	59.0%	64.2%
Ultimate loss ratio booked to at 12/31/05	60.8%	57.5%	56.5%	62.2%
Effect of actual 0.5% above provisional	($201,899)	($306,424)	($346,720)	($167,653)
Effect of actual 0.5% below provisional	$141,329	$202,240	$228,835	$167,653

Liquidity and Capital Resources

Sources and uses of funds. Our sources of funds are from insurance related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions, and processing and service fees.

On a consolidated basis, our cash and investments increased $94.6 million to $139.6 million as of December 31, 2005 as compared to $45.0 million at December 31, 2004. This 210% increase is mostly attributable to net proceeds of $44.9 million from a stockholder rights offering and $29.1 million from the issuance of trust preferred securities during 2005. These amounts exclude restricted cash and investments of $13.8 million and $6.5 million at December 31, 2005 and 2004, respectively, which secure the credit exposure of third parties arising from our various quota share reinsurance treaties and agency agreements.

Net cash provided by our consolidated operating activities was $29.5 million during 2005 compared to $7.3 million during 2004. The increase in operating cash flow primarily resulted from increased premiums collected of $32.9 million due largely to the assumption from Clarendon of business produced by HGA and the issuance of AHIC policies for business produced by HGA since July 1, 2005. Also contributing to the increase in collected premium is the 100% retention of the Texas non-standard auto premium produced by PGA. Prior to October 1, 2004, we retained only 45% of this business. Partially offsetting the increased operating cash flow is a $4.6 million increase in paid operating expenses due mostly to additional ceding commissions paid to Clarendon for the assumed premium, paid incentive compensation and paid retail agent profit sharing commissions. Also partially offsetting the increased operating cash flow is a $4.0 million increase in paid loss and loss adjustment expenses due mostly to the AHIC direct and assumed business produced by HGA during the last half of 2005 as well as the 100% retention of the Texas non-standard auto premium produced by PGA. Additional paid interest of $1.1 million from the trust preferred securities and $1.1 million in additional tax deposits also partially offset the increase in collected premium.

Cash used by investing activities during 2005 was $73.1 million as compared to $4.0 million used during 2004. The increase in cash used in investing activities is mainly due to increased purchases of debt and equity securities of $51.9 million, increased net purchases of short-term investments of $12.2 million, a decrease in net maturities and redemptions of securities of $4.4 million and a $0.4 million increase in cash and investments transferred to restricted accounts.

Cash provided by financing activities during 2005 was $75.1 million as compared to cash used in financing activities of $0.9 million during 2004. The cash provided in 2005 was from net proceeds of $44.9 million from the stockholder rights offering, $30.0 million from the issuance of trust preferred securities net of debt issuance costs and $0.2 million from the exercise of stock options. The cash used in 2004 was from $1.0 million repaid on a note payable that was partially offset by $48 thousand in proceeds from the exercise of stock options.

As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of December 31, 2005, Hallmark had $2.0 million in cash and invested assets. Cash and invested assets of our non-insurance subsidiaries were $3.6 million as of December 31, 2005.

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 TDI, 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 2005, AHIC's ordinary dividend capacity was $1.5 million. PIIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholder's surplus or prior year's net investment income, without prior written approval from AZDOI. During 2005, PIIC's ordinary dividend capacity was $0.8 million. Neither AHIC nor PIIC paid a dividend to Hallmark during 2005. The maximum dividend that AHIC can pay Hallmark in 2006 without prior approval from TDI is $6.4 million. The maximum dividend that PIIC can pay Hallmark in 2006 without prior approval from AZDOI is $1.6 million.

TDI regulates financial transactions between AHIC and affiliated companies. Applicable regulations require TDI's approval of management fees, expense sharing contracts and similar transactions. PGA paid $1.8 million and $0.6 million in management fees to Hallmark during 2005 and 2004, respectively. AZDOI regulates financial transactions between PIIC and affiliated companies. Applicable regulations require AZDOI's approval of management fees, expense sharing contracts and similar transactions. PIIC paid $1.2 million in management fees to

PGA during each of 2005 and 2004.

Statutory capital and surplus is calculated as statutory assets less statutory liabilities. TDI requires that AHIC maintain minimum statutory capital and surplus of $2.0 million and AZDOI requires that PIIC maintain minimum statutory capital and surplus of $1.5 million. As of December 31, 2005, AHIC and PIIC each significantly exceeded the minimum required statutory capital and surplus. At December 31, 2005, AHIC reported statutory capital and surplus of $63.7 million, which reflects an increase of $52.2 million from the $11.5 million reported at December 31, 2004. At December 31, 2005, PIIC reported statutory capital and surplus of $36.3 million, which is $22.3 million more than the $14.0 million reported at December 31, 2004. AHIC reported a statutory net loss of $4.6 million during 2005 compared to statutory net income of $1.5 million in 2004. The net loss was primarily due to the statutory recognition of acquisition costs from the retention of business produced by HGA. These costs are deferred over the life of the underlying policies under GAAP. PIIC reported statutory net income of $2.7 million during 2005 compared to $3.4 million in 2004. At December 31, 2005, AHIC's premium-to-surplus percentage was 94% as compared to 122% for the year ended December 31, 2004. PIIC's premium-to-surplus percentage was 79% for the year ended December 31, 2005 as compared to 135% for the year ended December 31, 2004.

Credit facility. On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit agreement was amended on July 15, 2005, and was further amended and restated on January 27, 2006. The restated credit agreement provides for a $20.0 million revolving credit facility, with a $5.0 million letter of credit sub-facility. The borrowings under the revolving credit facility will accrue interest at an annual rate of three month LIBOR plus 2.00% and we will pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the restated credit agreement are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets (subject to applicable insurance law and regulations). The restated credit agreement contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of December 31, 2005, there were no outstanding amounts due under our credit facility, and we were in compliance with or had obtained waivers of all of our covenants. In the third quarter of 2005, we issued a $4.0 million letter of credit under the sub-facility to collateralize certain obligations under the agency agreement between HGA and Clarendon effective July 1, 2004. In January, 2006, we borrowed $15.0 million under the revolving credit facility in connection with the TGA acquisition. (See, "Item 1. Business – Recent Events.")

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

Other debt obligations. On January 3, 2006, we executed a promissory note payable to Newcastle in the amount of $12.5 million in order to obtain funding to complete the acquisition of Aerospace. The promissory note bears interest at 10% per annum prior to maturity and at the maximum rate allowed under applicable law upon default. Interest is payable on the first business day of each month. The principal of the promissory note, together with accrued but unpaid interest, is due on demand at any time after June 30, 2006.

On January 27, 2006, we issued $25.0 million in subordinated convertible promissory notes to the Opportunity Funds. Each convertible note bears interest at 4% per annum, which rate increases to 10% per annum in the event of default. Interest is payable quarterly in arrears commencing March 31, 2006. Principal and all accrued but unpaid interest is due at maturity on July 27, 2007. Subject to shareholder approval, the convertible notes are convertible by the holders into approximately 19.5 million shares of our common stock (subject to certain anti-dilution provisions), and will be automatically converted to such common stock at maturity.

Long-term contractual obligations. Set forth below is a summary of long-term contractual obligations as of December 31, 2005 (in thousands). Amounts represent estimates of gross undiscounted amounts payable over time. In addition, certain losses and LAE are ceded to others under reinsurance contracts and are, therefore, recoverable. Such potential recoverables are not reflected in the table.

	Estimated Payments by Period				
	Total	**2006**	**2007-2008**	**2009-2010**	**After 2010**
Notes payable	30,928	-	-	-	30,928
Interest on note payable	68,366	2,318	4,635	4,635	56,778
Unpaid losses and loss adjustment expenses	26,321	15,187	8,739	1,737	658
Operating leases	4,027	1,103	1,964	773	187

Conclusion. Based on 2006 budgeted and year-to-date cash flow information, we believe that we have sufficient liquidity to meet our projected insurance obligations, operational expenses and capital expenditure requirements for the foreseeable future. However, we expect additional capital to be required to satisfy the debt obligations to Newcastle which are payable on demand after June 30, 2006. We presently intend to retire this debt through a rights offering of our common stock to existing shareholders during the first half of 2006. However, there can be no assurance that we will be able to successfully complete such rights offering.

Results of Operations

Fiscal 2005 versus Fiscal 2004

Total revenues for 2005 increased $23.9 million, or 37.9%, as compared to 2004, primarily as a result of a $19.5 million increase in revenues from our Commercial Insurance Operation due to the transition which began in the third quarter of 2005 of our premium produced by HGA from Clarendon to AHIC. Income before tax for 2005 increased $4.9 million over 2004. The improvement in operating earnings reflects additional investment income on capital raised in 2005, the transition of the commercial business and improved underwriting results.

The following is additional business segment information for the twelve months ended December 31, 2005 and 2004 (in thousands):

	2005	2004
Revenues		
Personal Insurance Operation	$ 43,907	$ 39,555
Commercial Insurance Operation	43,067	23,563
Corporate	61	3
Consolidated	$ 87,035	$ 63,121
Pre-tax Income		
Personal Insurance Operation	$ 11,647	$ 8,109
Commercial Insurance Operation	6,651	3,028
Corporate	(4,830)	(2,535)
Consolidated	$ 13,468	$ 8,602

Personal Insurance Operation

Net premium written by our Personal Insurance Operation increased $3.9 million during 2005 to $37.0 million compared to $33.1 million during 2004. The increase was due mainly to AHIC assuming 100% of the Texas non-standard automobile business produced by AHGA and underwritten by a third party, effective October 1, 2004. Prior to October 1, 2004, AHIC assumed only 45% of this business. Total premium production for 2005 declined $6.6 million, or 15.4%, to $36.4 million from the $43.0 million produced in 2004. The decline in produced premium reflected increased rate competition.

Revenue for our Personal Insurance Operation increased 11.0% to $43.9 million for 2005 from $39.6 million for 2004. Increased net premium earned of $5.0 million due to higher assumed premium volume was the primary cause of this increase. Also driving the increased revenue was a $0.9 million increase in investment income due to an increase in the investment portfolio from the completion of our capital plan. These increases were partially offset by a $1.2 million decrease in ceding commission income resulting from AHIC assuming 100% of the Texas non-standard automobile business effective October 1, 2004.

Pre-tax income for our Personal Insurance Operation increased $3.5 million, or 43.6%, for 2005 compared to 2004. Net investment income and realized gains and losses contributed $1.0 million to the increase in pre-tax income for 2005 over 2004. Improved underwriting results as evidenced by a loss ratio of 56.7% in 2005 as compared to 59.3% in 2004 contributed $1.0 million to the increase in pre-tax income in 2005. Taking into consideration the effect on ceding commissions, loss and LAE and premium production costs, the changes in premium volume produced and assumed contributed approximately $0.9 million to the increase in pre-tax income. Lower technical service costs from integrating PIIC's back office systems that were previously outsourced contributed $0.4 million and lower salary and related expenses contributed $0.3 million to the increase in pre-tax income.

Commercial Insurance Operation

Beginning in the third quarter of 2005, our Commercial Insurance Operation began retaining written premium through AHIC. Our Commercial Insurance Operation written premium was accomplished through the assumption of in-force policies from Clarendon at July 1, 2005, the assumption of Clarendon policies issued subsequent to July 1, 2005, and the issuance of AHIC policies. This resulted in net written premium of $51.2 million for 2005.

Total revenue for our Commercial Insurance Operation of $43.1 million for 2005 was $19.5 million more than the $23.6 million reported in 2004. This 82.8% increase in total revenue was primarily due to net premiums earned of $21.8 million from the issuance of AHIC policies and the assumption of premium from Clarendon for business produced by HGA. Increased net investment income contributed $1.5 million to the increase in revenue. These increases in revenue were partially offset by lower ceding commission revenue of $3.2 million and lower processing and service fees of $0.6 million, in both cases due to the shift from a third party agency structure to an insurance underwriting structure. Total earned premium generated by our Commercial Insurance Operation (including premium retained by Clarendon) for 2005 was $78.1 million as compared to $72.5 million for 2004.

Pre-tax income for our Commercial Insurance Operation of $6.6 million for 2005 increased $3.6 million, or 119.6%, over the $3.0 million reported for 2004. Increased revenue, as discussed above, was the primary reason for the increase in pre-tax income, partially offset by loss and LAE of $12.6 million and additional production expenses of $3.2 million caused by increased retail agent commissions from higher premium production as well as additional ceding commission expense from the assumption of premium from Clarendon.

Corporate

Corporate pre-tax loss was $4.8 million for 2005 as compared to $2.5 million for 2004. The increase was due mostly to additional interest expense of $1.2 million from the issuance of trust preferred securities in June 2005, increased salary expense of $0.6 million from increased headcount (including the transfer of accounting positions from both operations to Corporate late in 2004) and additional audit and legal fees of $0.2 million due primarily to the implementation of our capital plan in 2005.

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 our Personal Insurance Operation partially offset by a $3.7 million increase in total revenues from our Commercial Insurance Operation. However, income before tax and extraordinary gain for 2004 increased $7.9 million as compared to 2003. The improvement in operating earnings in 2004 reflected better underwriting results for our Personal Insurance Operation, additional commission revenue in our Commercial Insurance Operation 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 Insurance Operation	$ 39,555	$ 49,665
Commercial Insurance Operation	23,563	19,891
Corporate	3	3
Consolidated	$ 63,121	$ 69,559
Pre-tax Income		
Personal Insurance Operation	$ 8,109	$ 1,950
Commercial Insurance Operation	3,028	1,311
Corporate	(2,535)	(2,575)
Consolidated	$ 8,602	$ 686

Personal Insurance Operation

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 our Personal Insurance Operation decreased $10.1 million, or 20.4%, to $39.6 million in 2004 compared to $49.7 million in 2003.

Although revenue for our Personal Insurance Operation declined, our 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 PIIC 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 Insurance Operation

Total revenue for our Commercial Insurance Operation 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 our Commercial Insurance Operation for 2004 was $72.5 million compared to $62.9 million for 2003. We did not bear the primary underwriting risk for this business in 2004 or 2003 and, therefore, the resulting premiums and claims are not reflected in our reported results.

Pre-tax income for the Commercial Insurance Operation 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. We 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.

Effects of Inflation

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

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

Interest Rate Risk

Our investment portfolio consists principally of investment-grade, fixed income securities, all of which are classified as available-for-sale. Accordingly, the primary market risk exposure to these securities is interest rate risk. In general, the fair market value of a portfolio of fixed income securities increases or decreases inversely with changes in market interest rates, while net investment income realized from future investments in fixed income securities increases or decreases along with interest rates. The fair value of the Company's fixed income securities as of December 31, 2005 was $87.3 million. The effective duration of the portfolio as of December 31, 2005 was 4.2 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 4.2%, or $3.6 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 4.2%, or $3.6 million, increase in the market value of the fixed income investment portfolio.

Credit Risk

An additional exposure to our fixed income securities portfolio is credit risk. We attempt to manage the credit risk by investing only in investment-grade securities and limiting our exposure to a single issuer. As of December 31, 2005, our fixed income investments were in the following: corporate securities – 62.4%; municipal securities – 32.8%; and U.S. Treasury securities – 4.8%. As of December 31, 2005, all of our fixed income securities were rated investment grade by nationally recognized statistical rating organizations.

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

Equity Price Risk

Investments in equity securities which are subject to equity price risk make up 3.3% of our 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 our equity securities as of December 31, 2005 was $3.4 million. The fair value of our equity securities would increase or decrease by $1.0 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 1.2%. 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.

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

None.

Item 9A. Controls and Procedures.

Our Chief Executive Officer and Chief Financial Officer have evaluated our disclosure controls and procedures and have concluded that such controls and procedures are effective as of the end of the period covered by this report. During the most recent fiscal quarter, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The information required by 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 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 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 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 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.

PART IV

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 Item 8 of this report:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets at December 31, 2005 and 2004
Consolidated Statements of Operations for the Years Ended December 31, 2005, 2004 and 2003
Consolidated Statements of Shareholders' Equity and Comprehensive Income for the Years Ended December 31, 2005, 2004 and 2003
Consolidated Statements of Cash Flows for the Years Ended December 31, 2005, 2004 and 2003
Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules

The following financial statement schedules are included in this report:

Unaudited Selected Quarterly Information	Page F-33
Schedule II – Condensed Financial Information of Registrant – Hallmark Financial Services, Inc. (Parent Company Only)	Page F-33
Schedule III – Supplemental Insurance Information	Page F-36
Schedule IV – Reinsurance	Page F-37
Schedule VI – Supplemental Information Concerning Property-Casualty Insurance Operations	Page F-38

(a)(3) 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)	Amended and Restated By-Laws of the registrant, (incorporated by reference to Exhibit 3(b) to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
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(a)	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).
4(b)	Indenture dated June 21, 2005, between Hallmark Financial Services, Inc. and JPMorgan Chase Bank, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).
4(c)	Amended and Restated Declaration of Trust of Hallmark Statutory Trust I dated as of June 21, 2005, among Hallmark Financial Services, Inc., as sponsor, Chase Bank USA, National Association, as Delaware trustee, and JPMorgan Chase Bank, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).

4(d) Form of Junior Subordinated Debt Security Due 2035 [included in Exhibit 4(b) above].

4(e) Form of Capital Security Certificate [included in Exhibit 4(c) above].

4(f) Credit Agreement dated June 29, 2005, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed July 6, 2005).

4(g) First Amendment to Credit Agreement dated July 15, 2005, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 4(g) to the registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).

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

4(i) Promissory Note dated January 3, 2006, in the amount of $12,500,000 payable to Newcastle Partners, L.P. (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed January 5, 2006).

4(j) Form of Convertible Promissory Note dated January 27, 2006, payable to Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006).

10(a) Office Lease for 14651 Dallas Parkway, 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) Tenth Amendment to Office Lease for 14651 Dallas Parkway, 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(c) 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(d)* 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(e)* 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(f)* 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(g)* 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(h)* 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(i)* 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(j)* 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(k)* Hallmark Financial Services, Inc. 2005 Long Term Incentive Plan (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 3, 2005).

10(l)* Form of Incentive Stock Option Grant Agreement (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed June 3, 2005).

10(m)* Form of Non-qualified Stock Option Agreement (incorporated by reference to Exhibit 10.3 to the registrant's Current Report on Form 8-K filed June 3, 2005).

10(n) Guarantee Agreement dated as of June 21, 2005, by Hallmark Financial Services, Inc. for the benefit of the holders of trust preferred securities (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).

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

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

Exhibit Number	Description
21+	List of subsidiaries of the registrant.
23+	Consent of KPMG 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.

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 22, 2006	/s/ Mark E. Schwarz Mark E. Schwarz, Chairman and Chief Executive Officer (Principal Executive Officer)
Date:	March 22, 2006	/s/ Mark J. Morrison Mark J. Morrison, EVP, Chief Operating Officer and Chief Financial Officer (Principal Financial Officer)
Date:	March 22, 2006	/s/ Jeffrey R. Passmore 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 22, 2006	/s/ Mark E. Schwarz Mark E. Schwarz, Director
Date:	March 22, 2006	/s/ James H. Graves James H. Graves, Director
Date:	March 22, 2006	/s/ George R. Manser George R. Manser, Director
Date:	March 22, 2006	/s/ Scott T. Berlin Scott T. Berlin, Director

Exhibit 21

Subsidiaries of Hallmark Financial Services, Inc.

Name of Subsidiary	Jurisdiction of Incorporation
American Hallmark Insurance Company of Texas*	Texas
Hallmark Finance Corporation*	Texas
ACO Holdings, Inc.*	Texas
Hallmark Claims Service, Inc. (d/b/a Phoenix General Agency)	Texas
American Hallmark General Agency, Inc. (d/b/a Phoenix General Agency)	Texas
Hallmark Underwriters, Inc.*	Texas
American Hallmark Agencies, Inc.*	Texas
Allrisk Insurance Agency, Inc.*	Texas
Phoenix Indemnity Insurance Company*	Arizona
Hallmark General Agency, Inc.*	Texas
Effective Claims Management, Inc.*	Texas
Texas General Agency, Inc.*	Texas
Gulf States Insurance Company*	Oklahoma
Pan American Acceptance Corporation*	Texas
TGA Special Risk, Inc.*	Texas
Aerospace Holdings, LLC*	Texas
Aerospace Flight, Inc.*	Texas
Aerospace Insurance Managers, Inc.*	Texas
Aerospace Claims Management Group, Inc.*	Texas
Aerospace Special Risk, Inc.*	Texas
Mannequin PCC Ltd. Cell A-22*	Guernsey

* Conducts business under their corporate name.

Exhibit 23

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 17, 2006, relating to the consolidated balance sheets of Hallmark Financial Services, Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and comprehensive income and cash flows for each of the years in the three-year period ended December 31, 2005 and all financial statement schedules, which report appears in the December 31, 2005 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 22, 2006

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 22, 2006

/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 22, 2006

/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, 2005, 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 22, 2006

/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, 2005, 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 22, 2006

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Hallmark Financial Services, Inc. and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2005. 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, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, 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 17, 2006

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2005 and 2004
(In thousands)

ASSETS	2005	2004
Investments:		
Debt securities, available-for-sale, at fair value	$ 79,360	$ 28,206
Equity securities, available-for-sale, at fair value	3,403	3,580
Short-term investments, available-for-sale, at fair value	12,281	335
Total investments	95,044	32,121
Cash and cash equivalents	44,528	12,901
Restricted cash and investments	13,802	6,509
Prepaid reinsurance premiums	767	-
Premiums receivable	26,530	4,103
Accounts receivable	2,083	3,494
Reinsurance recoverable	444	3,083
Deferred policy acquisition costs	9,164	7,475
Excess of cost over fair value of net assets acquired	4,836	4,836
Intangible assets	459	486
Deferred federal income taxes	3,992	5,173
Prepaid expenses	802	813
Other assets	6,455	1,517
	$ 208,906	$ 82,511
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	$ 30,928	$ -
Unpaid losses and loss adjustment expenses	26,321	19,648
Unearned premiums	36,027	6,192
Unearned revenue	4,055	11,283
Reinsurance balances payable	116	-
Accrued agent profit sharing	2,173	1,875
Accrued ceding commission payable	11,430	1,695
Pension liability	2,932	2,180
Current federal income tax payable	300	1,343
Accounts payable and other accrued expenses	9,436	5,639
	123,718	49,855
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Common stock, $.03 par value, authorized 100,000,000 shares; issued 86,856,610 shares in 2005 and 36,856,610 shares in 2004	2,606	1,106
Capital in excess of par value	62,907	19,647
Retained earnings	22,289	13,103
Accumulated other comprehensive loss	(2,597)	(759)
Treasury stock, 14,819 shares in 2005 and 379,319 shares in 2004, at cost	(17)	(441)
Total stockholders' equity	85,188	32,656
	$ 208,906	$ 82,511

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
for the years ended December 31, 2005, 2004 and 2003
(In thousands, except per share amounts)

	2005	2004	2003
Gross premiums written	$ 89,467	$ 33,389	$ 43,338
Ceded premiums written	(1,215)	(322)	(6,769)
Net premiums written	88,252	33,067	36,569
Change in unearned premiums	(29,068)	(622)	5,406
Net premiums earned	59,184	32,445	41,975
Investment income, net of expenses	3,836	1,386	1,198
Realized gains (losses)	58	(27)	(88)
Finance charges	2,044	2,183	3,544
Commission and fees	16,703	21,100	17,544
Processing and service fees	5,183	6,003	4,900
Other income	27	31	486
Total revenues	87,035	63,121	69,559
Losses and loss adjustment expenses	33,784	19,137	30,188
Other operating costs and expenses	38,492	35,290	37,386
Interest expense	1,264	64	1,271
Amortization of intangible asset	27	28	28
Total expenses	73,567	54,519	68,873
Income before income tax and extraordinary gain	13,468	8,602	686
Income tax expense	4,282	2,753	25
Income before extraordinary gain	9,186	5,849	661
Extraordinary gain	-	-	8,084
Net income	$ 9,186	$ 5,849	$ 8,745
Basic earnings per share:			
Income before extraordinary gain	$ 0.13	$ 0.14	$ 0.02
Extraordinary gain	-	-	0.28
Net income	$ 0.13	$ 0.14	$ 0.30
Diluted earnings per share:			
Income before extraordinary gain	$ 0.13	$ 0.14	$ 0.02
Extraordinary gain	-	-	0.28
Net income	$ 0.13	$ 0.14	$ 0.30

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, 2005, 2004 and 2003
(in thousands)

	Number of Shares	Par Value	Capital In Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Number of Shares	Total Stockholders' Equity	Comprehensive Income (Loss)
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					755			755	755
Total other comprehensive income before tax					109			109	109
Tax effect on other comprehensive income					(40)			(40)	(40)
Other comprehensive income after tax					69			69	69
Comprehensive income									$ 8,814
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 losses included in net income					(218)			(218)	(218)
Net unrealized gains on securities					220			220	220
Total other comprehensive income before tax					(978)			(978)	(978)
Tax effect on other comprehensive income					312			312	312
Other comprehensive income 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	

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (Continued)
for the years ended December 31, 2005, 2004 and 2003
(in thousands)

	Number of Shares	Par Value	Capital In Excess of Par Value	Retained Earnings	Accumlated Other Comprehensive Income (Loss)	Treasury Stock	Number of Shares	Total Stockholders' Equity	Comprehensive Income (Loss)
Balance at December 31, 2004	36,857	$ 1,106	$ 19,647	$ 13,103	$ (759)	$ (441)	379	$ 32,656	
Rights offering	50,000	1,500	43,391					44,891	
Amortization of fair value of stock options granted			63					63	
Stock options exercised			(194)			424	(364)	230	
Comprehensive income:									
Net income				9,186				9,186	$ 9,186
Other comprehensive income:									
Additional minimum pension liability					(761)			(761)	(761)
Net unrealized holding gains (losses) arising during period					(1,932)			(1,932)	(1,932)
Reclassification adjustment for losses included in net income					(107)			(107)	(107)
Net unrealized gains (losses) on securities					(2,039)			(2,039)	(2,039)
Total other comprehensive income before tax					(2,800)			(2,800)	(2,800)
Tax effect on other comprehensive income					962			962	962
Other comprehensive income after tax					(1,838)			(1,838)	(1,838)
Comprehensive income									$ 7,348
Balance at December 31, 2005	86,857	$ 2,606	$ 62,907	$ 22,289	$ (2,597)	$ (17)	15	$ 85,188	

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the years ended December 31, 2005, 2004 and 2003
(In thousands)

	2005	2004	2003
Cash flows from operating activities:			
Net income	$ 9,186	$ 5,849	$ 8,745
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization expense	413	450	621
Deferred income tax expense (benefit)	2,143	(787)	114
Realized (gain) loss on investments	(58)	27	88
Change in prepaid reinsurance premiums	(767)	291	8,297
Change in premiums receivable	(22,427)	(70)	(1,276)
Change in accounts receivable	1,411	(99)	(1,266)
Change in deferred policy acquisition costs	(1,689)	(329)	(1,340)
Change in unpaid losses and loss adjustment expenses	6,673	(8,808)	(5,097)
Change in unearned premiums	29,835	330	(12,785)
Change in unearned revenue	(7,228)	1,093	3,271
Change in accrued agent profit sharing	298	364	944
Change in reinsurance recoverable	2,639	7,433	12,817
Change in reinsurance balances payable	116	-	(3,082)
Change in current federal income tax payable/recoverable	(1,043)	1,968	(592)
Change in accrued ceding commission payable	9,735	531	(1,372)
Gain on acquisition of subsidiary	-	-	(8,084)
Change in all other liabilities	3,817	(1,661)	419
Change in all other assets	(3,512)	757	44
Net cash provided by operating activities	29,542	7,339	466
Cash flows from investing activities:			
Purchases of property and equipment	(532)	(389)	(476)
Acquisition of subsidiary, net of cash received	-	-	6,945
Premium finance notes repaid, net of finance notes originated	-	43	11,550
Change in restricted cash and investments	(3,835)	(3,458)	(4,294)
Purchases of debt and equity securities	(58,605)	(6,670)	(19,075)
Maturities of fixed income securities	10	5,034	1,403
Redemptions of investment securities	1,737	1,081	6,944
Net (purchases) redemptions of short-term investments	(11,832)	344	8,904
Net cash provided by (used in) investing activities	(73,057)	(4,015)	11,901
Cash flows from financing activities:			
Proceeds from borrowings	30,928	-	-
Debt issuance costs	(907)	-	-
Net repayments to premium finance lender	-	-	(10,905)
Proceeds from rights offering	44,891	-	10,000
Proceeds from exercise of employee stock options	230	48	17
Repayment of borrowings	-	(991)	(9,412)
Net cash provided by (used in) financing activities	75,142	(943)	(10,300)
Increase in cash and cash equivalents	31,627	2,381	2,067
Cash and cash equivalents at beginning of year	12,901	10,520	8,453
Cash and cash equivalents at end of year	$ 44,528	$ 12,901	$ 10,520
Supplemental cash flow information:			
Interest (paid)	$ (1,167)	$ (64)	$ (1,456)
Income taxes (paid)	$ (3,182)	$ (1,700)	$ (475)

We transferred $3.4 million of fixed maturity investments from debt securities, available-for-sale to restricted investments during 2005 and 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

1. **Accounting Policies:**

Basis of Presentation

The accompanying consolidated financial statements include the accounts and operations of Hallmark Financial Services, Inc. and its subsidiaries. Intercompany accounts and transactions have been eliminated. The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ("GAAP") which, as to American Hallmark Insurance Company of Texas ("AHIC") and Phoenix Indemnity Insurance Company ("PIIC"), 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 treasury bills which are reported at market value and 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

We consider 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 is refunded to the insured. Insurance premiums written include gross policy fees of $3.9 million, $2.7 million and $3.0 million and policy fees, net of reinsurance, of $3.9 million, $2.7 million and $2.3 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Recognition of Commission Revenues and Expenses of Commercial Insurance Operation

Commission revenues and commission expenses related to insurance policies issued by Hallmark General Agency, Inc. ("HGA") on behalf of Clarendon National Insurance Company ("Clarendon") are recognized pro rata during the period covered by the policy. Profit sharing commission is calculated and recognized when the loss ratio, as determined by a qualified actuary, deviates from contractual targets. We receive a provisional commission as policies are produced as an advance against the later determination of the profit sharing commission actually earned. The profit sharing commission is an estimate that varies with the estimated loss ratio and is sensitive to changes in that estimate. The following table details the profit sharing commission revenue sensitivity to the actual ultimate loss ratio for each effective quota share treaty at 0.5% above and below the provisional loss ratio.

	Treaty Effective Dates			
	7/1/01	7/1/02	7/1/03	7/1/04
Provisional loss ratio	60.0%	59.0%	59.0%	64.2%
Ultimate loss ratio booked to at 12/31/05	60.8%	57.5%	56.5%	62.2%
Effect of actual 0.5% above provisional	($201,899)	($306,424)	($346,720)	($167,653)
Effect of actual 0.5% below provisional	$141,329	$202,240	$228,835	$167,653

1. **Accounting Policies**, continued

As of December 31, 2005, we recorded a $1.7 million profit sharing payable for the quota share treaty effective July 1, 2001. We received a $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. We also recorded a $0.6 million receivable on the quota share treaty effective July 1, 2002, a $1.1 million receivable on the quota share treaty effective July 1, 2003 and a $1.0 million receivable on the quota share treaty effective July 1, 2004.

Recognition of Claim Servicing Fees

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

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

Finance Charges

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

We receive premium installment fees between $3.00 and $9.00 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.

1. **Accounting Policies**, continued

Property and Equipment

Property and equipment (including leasehold improvements), aggregating $4.1 million and $3.6 million, at December 31, 2005 and 2004, 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 2005, 2004 and 2003 was $0.4 million, $0.4 million and $0.6 million, respectively. Accumulated depreciation was $3.0 and $2.6 million at December 31, 2005 and 2004, respectively.

Premiums Receivable

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

Deferred Policy Acquisition Costs

Policy acquisition costs (mainly commission, underwriting and marketing expenses) that vary with and are primarily related to the production of new and renewal business are deferred and charged to operations over periods in which the related premiums are earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premium to be earned, related investment income, losses and loss 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 2005, we deferred $4.8 million of ceding commissions on the AHIC commercial business. As of December 31, 2005, we netted this $4.8 million of deferred ceding commissions against our deferred policy acquisition cost balance. During 2005, 2004 and 2003, the Company deferred ($33.3) million, ($22.6) million and ($21.0) million of policy acquisition costs and amortized $26.8 million, $22.3 million and $20.6 million of deferred policy acquisition costs, respectively. The net deferrals of policy acquisition costs were ($6.5) million, ($0.3) million and ($0.4) million for 2005, 2004 and 2003, respectively.

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, 2005, 2004 and 2003. The reserves for unpaid losses and loss adjustment expenses are estimated using individual case-basis valuations and statistical analyses. These estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, we believe that the reserves for unpaid losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

1. **Accounting Policies**, continued

Agent Profit Sharing Commissions

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

Reinsurance

We are routinely involved in reinsurance transactions with other companies. Reinsurance premiums, losses, and LAE 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 6.)

Leases

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

Income Taxes

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

Earnings Per Share

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

1. Accounting Policies, continued

Business Combinations

We account 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.

We acquired PIIC effective January 1, 2003. In consideration for PIIC, we cancelled $7.0 million of a $14.85 million balance on a note receivable from Millers American Group, Inc. ("Millers"). We had valued the note receivable on our balance sheet at its cost of $6.5 million. As of December 31, 2003, we 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 acquisition of PIIC was accounted for in accordance with FASB Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS 141"). This statement requires that we estimate the fair value of assets acquired and liabilities assumed by us as of the date of the acquisition. In accordance SFAS 141, we recognized an extraordinary gain of $8.1 million for the acquisition of PIIC in our Consolidated Statement of Operations for the twelve months ended December 31, 2003. The gain was calculated as the difference between the fair value of the net assets of PIIC of $14.6 million and the $6.5 million cost of the note receivable from Millers.

Intangible Assets

We account for our intangible assets according to SFAS 142. SFAS 142 supersedes Accounting Principles Boards ("APB") Opinion No. 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.

1. **Accounting Policies**, continued

Pursuant to SFAS 142, we have identified two components of goodwill and assigned the carrying value of these components into two reporting units: the Personal Insurance Operation, $2.7 million; and the Commercial Insurance Operation, $2.1 million. During 2005, 2004 and 2003, we completed the first step prescribed by SFAS 142 for testing for impairment and determined that there was no impairment.

Effective December 1, 2002, we acquired HGA and ECM. At acquisition, we valued the relationships with HGA's independent agents at $542,580. This asset is classified as an intangible asset and is being amortized on a straight-line basis over twenty years. We recognized $27,129 of amortization expense for the twelve months ending December 31, 2005 and will recognize $27,129 in amortization expense for each of the next five years and $323,287 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 for fixed income securities and equity securities are obtained from an independent pricing service or based on quoted market prices. (See Note 2.)

Restricted Cash and Investments: The carrying amount for restricted cash reported in the balance sheet approximates the fair value. Fair values for restricted fixed income securities are obtained from an independent pricing service or based on quoted market prices. (See Note 3.)

Notes Payable: The fair value for the notes payable as of December 31, 2005 was $30.9 million, calculated by discounting the future cash flows at our current fixed interest rate of 7.725%.

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

1. Accounting Policies, continued

Stock-based Compensation

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R, "Share-Based Payment" ("SFAS 123R"), which revises FASB Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). SFAS 123R eliminates an entity's ability to account for share-based payments using APB 25 and requires that all such transactions be accounted for using a fair value based method. In April 2005, the SEC deferred the effective date of SFAS 123R from the first interim or annual period beginning after June 15, 2005 to the next fiscal year beginning after June 15, 2005. SFAS 123R is not expected to have a material impact on our results of operations or financial position.

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

We have a stock compensation plan for key employees and non-employee directors that was approved by the shareholders on May 26, 2005. We had an employee stock option plan and a non-qualified stock option plan for non-employee directors, both of which expired in 2004. These plans are described more fully in Note 11. Prior to 2003, we accounted for these plans under the recognition and measurement provisions of APB 25, and related Interpretations. Effective January 1, 2003, we adopted, in accordance with SFAS 148, the fair value recognition provisions of SFAS 123. Under the prospective method of adoption selected by us 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 and net income per share if the fair value based method had been applied to all outstanding and unvested awards in each period.

	2005	2004	2003
Net income	$ 9,186	$ 5,849	$ 8,745
Add: stock-based employee compensation expenses included in reported net income, net of tax	41	20	30
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(48)	(27)	(68)
Pro forma net income	$ 9,179	$ 5,842	$ 8,707
Net income per share:			
Basic – as reported	$ 0.13	$ 0.14	$ 0.30
Basic – pro forma	$ 0.13	$ 0.14	$ 0.30
Diluted – as reported	$ 0.13	$ 0.14	$ 0.30
Diluted – pro forma	$ 0.13	$ 0.14	$ 0.29

Reclassification

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

2. Investments:

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

	Years ended December 31, 2005	2004	2003
Debt securities	$ 2,806	$ 1,127	$ 752
Equity securities	90	109	189
Short-term investments	161	82	102
Cash equivalents	832	82	171
	3,889	1,400	1,214
Investment expenses	(53)	(14)	(16)
Net investment income	$ 3,836	$ 1,386	$ 1,198

No investment in any entity or its affiliates exceeded 10% of stockholders' equity at December 31, 2005 or 2004.

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
As of December 31, 2005				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 4,331	$ -	$ 153	$ 4,178
Corporate debt securities	51,191	26	843	50,374
Municipal bonds	24,837	174	217	24,794
Mortgage backed securities	13	1	-	14
Total debt securities	80,372	201	1,213	79,360
Equity securities	3,505	270	372	3,403
Total debt and equity securities	$ 83,877	$ 471	$ 1,585	$ 82,763
As of 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

2. Investments, continued:

The amortized cost and estimated fair value of investments in debt and equity securities with a gross unrealized loss position at December 31, 2005 and 2004 (in thousands) is as follows:

	Amortized Cost	Fair Value	Gross Unrealized Loss
As of December 31, 2005			
4 Equity Positions	$ 1,677	$ 1,305	$ (372)
67 Bond Positions	70,956	69,684	(1,272)
	$ 72,633	$ 70,989	$ (1,644)
As of December 31, 2004			
1 Equity Position	$ 31	$ 27	$ (4)
6 Bond Positions	7,323	7,216	(107)
	$ 7,354	$ 7,243	$ (111)

The gross unrealized loss recorded at December 31, 2005 includes $59 thousand from securities placed in the restricted investment portfolio. All of the gross unrealized loss at December 31, 2005 is less than twelve months old and is considered a temporary decline in value as we see no other indications that the decline in value of these securities is permanent.

The amortized cost and estimated fair value of debt securities at December 31, 2005 by contractual maturity are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties.

Maturity (in thousands):	Amortized Cost	Fair Value
Due in one year or less	$ 10,188	$ 9,930
Due after one year through five years	27,245	26,697
Due after five years through ten years	39,669	39,518
Due after ten years	3,257	3,201
Mortgage-backed securities	13	14
	$80,372	$79,360

At December 31, 2005 and 2004, investments in debt securities with an approximate carrying value of $6.2 million and $2.6 million were on deposit with various state insurance departments as required by state insurance regulations.

3. Restricted Cash and Investments:

We have cash and investments held in trust accounts to secure the credit exposure of third parties arising from our various quota share reinsurance treaties and agency agreements. These funds are recorded on our balance sheet at fair value, with unrealized gains and losses reported as accumulated other comprehensive income, a component of shareholders' equity. The fair value of these funds as of December 31, 2005 and 2004 was $13.8 million and $6.5 million, respectively.

3. **Restricted Cash and Investments**, continued:

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
As of December 31, 2005				
Municipal bonds	$ 3,875	$ -	$ 23	$ 3,852
Corporate debt securities	4,096	-	36	4,060
Total debt securities	$ 7,971	$ -	$ 59	$ 7,912
Cash				5,890
Total restricted cash and investments				$ 13,802
As of December 31, 2004				
Municipal bonds	$ 2,561	$ 45	$ -	$ 2,606
Corporate debt securities	-	-	-	-
Total debt securities	$ 2,561	$ 45	$ -	$ 2,606
Cash				3,903
Total restricted cash and investments				$ 6,509

The amortized cost and estimated fair value of investments in debt securities held in trust as of December 31, 2005 by contractual maturity are as follows (in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 2,966	$ 2,947
Due after one year through 5 years	1,130	1,113
Due after 5 years through 10 years	3,875	3,852
Due after 10 years	-	-
	$ 7,971	$ 7,912

4. **Other Assets**:

The following table details our other assets as of December 31, 2005 and 2004 (in thousands):

	2005	2004
Profit sharing commission receivable	$ 2,793	$ 380
Accrued investment income	1,562	417
Debt issuance costs	856	-
Fixed assets	1,148	693
Other assets	96	27
	$ 6,455	$ 1,517

Our profit sharing commission receivable increased $2.4 million in 2005 due to favorable loss development and improved commission terms negotiated in the middle of 2004. Our accrued investment income increased $1.1 million due to the investment of funds received in our capital plan implemented in 2005.

5. 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:

	2005	2004	2003
Balance at January 1	$ 19,648	$ 28,456	$ 17,667
Plus acquisition of Phoenix at January 1	-	-	10,338
Less reinsurance recoverables	1,948	7,259	9,256
Net Balance at January 1	17,700	21,197	18,749
Incurred related to:			
Current year	36,184	20,331	29,724
Prior years	(2,400)	(1,194)	464
Total incurred	33,784	19,137	30,188
Paid related to:			
Current year	17,414	10,417	21,895
Prior years	8,073	12,217	5,845
Total paid	25,487	22,634	27,740
Net Balance at December 31	25,997	17,700	21,197
Plus reinsurance recoverables	324	1,948	7,259
Balance at December 31	$ 26,321	$ 19,648	$ 28,456

The $2.4 million and $1.2 million favorable development in prior accident years recognized in 2005 and 2004, respectively, represent normal changes in actuarial estimates. 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.

6. Reinsurance:

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

For policies originated prior to April 1, 2003, we assumed the reinsurance of 100% of the Texas non-standard auto business produced by Phoenix General Agency ("PGA") and underwritten by State & County and retroceded 55% of the business to Dorinco Reinsurance Company ("Dorinco"). Under this arrangement, we remain obligated to policyholders in the event that Dorinco does not meet its obligations under the retrocession agreement. From April 1, 2003 through September 30, 2004, we assumed the reinsurance of 45% of the Texas non-standard automobile policies produced by PGA and underwritten either by State & County (for policies written from April 1, 2003 through September 30, 2003) or Old American County Mutual Fire Insurance Company ("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, we are obligated to policyholders only for the portion of the risk that we assumed. Effective October 1, 2004, we assume and retain the reinsurance of 100% of the Texas non-standard automobile policies produced by PGA and underwritten by OACM.

Under our prior insurance arrangements with Dorinco, we earned ceding commissions based on loss ratio experience on the portion of policies reinsured by Dorinco. We 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, 2005 and 2004, the accrued ceding commission payable to Dorinco was \$0.4 million and \$1.0 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 shows premiums directly written, assumed and ceded and reinsurance loss recoveries by period (in thousands):

	Twelve Months Ended December 31,		
	2005	2004	2003
Written premium:			
Direct	$ 44,237	$ 18,941	$ 22,359
Assumed	45,230	14,448	20,979
Ceded	(1,215)	(322)	(6,769)
Net written premium	$ 88,252	$ 33,067	$ 36,569
Earned premium:			
Direct	$ 23,747	$ 19,028	$ 23,067
Assumed	35,885	14,030	34,380
Ceded	(448)	(613)	(15,472)
Net earned premium	$ 59,184	$ 32,445	$ 41,975
Reinsurance recoveries	$ (492)	$ 163	$ 11,071

The following table presents our reinsurance recoverable balance as of December 31, 2005 by reinsurer (in thousands):

Reinsurer	Reinsurance Recoverable	A.M. Best Rating of Reinsurer
Dorinco Reinsurance Company	$ 426	A- (Excellent)
GE Reinsurance Corporation	10	A (Excellent)
Platinum Underwriters Reinsurance, Inc.	8	A (Excellent)
Total Reinsurance Recoverable	$ 444	

Our Personal Insurance Operation presently retains 100% of the risk associated with all non-standard auto policies marketed by PGA. Our Commercial Insurance Operation currently purchases reinsurance for the following exposures:

- **Property Catastrophe** – Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our commercial property insurance lines. Catastrophes might include multiple claims and policyholders. Catastrophes include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Our property catastrophe reinsurance is excess-of-loss reinsurance, which provides us reinsurance coverage for losses in excess of an agreed-upon amount. We utilize catastrophe models to assist in determining appropriate retention and limits to purchase. The terms of our current property catastrophe reinsurance effective, October 1, 2005, are:
    - We retain the first $1 million of property catastrophe losses; and
    - Our reinsurers reimburse us 95% for each $1 of loss in excess of our $1 million retention up to $4.75 million for each catastrophic occurrence, subject to a two event maximum for the contractual term.
- **Commercial Property** – Our commercial property reinsurance reduces the financial impact a single-event or catastrophic loss may have on our results. It is excess-of-loss coverage. The terms of our current commercial property reinsurance effective, July 1, 2005, are:
    - We retain first $500 thousand of loss for each commercial property risk;
    - Our reinsurers reimburse us for the next $4.5 million for each commercial property risk; and
    - Individual risk facultative reinsurance is purchased on any commercial property with limits above $5 million.
- **Commercial Umbrella** – Our commercial umbrella reinsurance reduces the financial impact of losses in this line of business. Our commercial umbrella reinsurance is quota-share reinsurance, in which the reinsurers share a proportional amount of the premiums and losses. Under our current commercial umbrella reinsurance effective, July 1, 2005, we retain 10% of the premiums and losses and cede 90% to our reinsurers.
- **Commercial Casualty** – Our commercial casualty reinsurance reduces the financial impact a single-event loss may have on our results. It is excess-of-loss coverage. The terms of our current commercial casualty reinsurance effective, July 1, 2005, are:
    - We retain the first $500 thousand of any commercial liability loss, including commercial automobile liability; and
    - Our reinsurers reimburse us for the next $500 thousand for each commercial liability loss, including commercial automobile liability.

7. Notes Payable:

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

8. Credit Facility:

On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit agreement was amended on July 15, 2005, to reduce the interest rate. Under this credit facility, the maximum amount available to us from time to time during 2005 was $7.5 million, which could include up to $2.0 million under a revolving line of credit, up to $3.5 million in five-year term loans and up to $7.5 million in five-year stand-by letters of credit. The borrowings under this credit facility accrued interest at an annual rate of three month LIBOR plus 2.00% and we paid letter of credit fees at the rate of 1.00% per annum. Our obligations under the credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of December 31, 2005, there were no outstanding amounts due under our credit facility, and we were in compliance with or had obtained waivers of all of our covenants. In the third quarter of 2005, we issued a $4.0 million letter of credit under this facility to collateralize certain obligations under the agency agreement between HGA and Clarendon, effective July 1, 2004. This credit agreement was amended and restated in January, 2006. (See Note 17.)

9. **Segment Information**:

We have pursued our business activities through subsidiaries whose operations are organized into our Commercial Insurance Operation segment, which handles commercial insurance products and services, and our Personal Insurance Operation segment, which handles non-standard personal automobile insurance products and services. Our Commercial Insurance Operation markets and underwrites commercial insurance policies through approximately 170 independent agencies operating primarily in the non-urban areas of Texas, New Mexico, Idaho, Oregon, Montana and Washington. Our Personal Insurance Operation markets minimum limits non-standard automobile policies through approximately 760 independent agents in Texas, New Mexico and Arizona.

The following is additional business segment information for the twelve months ended December 31, 2005, 2004 and 2003 (in thousands):

	2005	2004	2003
Revenues			
Personal Insurance Operation	$ 43,907	$ 39,555	$ 49,665
Commercial Insurance Operation	43,067	23,563	19,891
Corporate	61	3	3
Consolidated	$ 87,035	$ 63,121	$ 69,559
Depreciation Expense			
Personal Insurance Operation	$ 226	$ 266	$ 218
Commercial Insurance Operation	144	144	370
Corporate	16	13	6
Consolidated	$ 386	$ 423	$ 594
Interest Expense			
Personal Insurance Operation	$ 10	$ 14	$ 389
Commercial Insurance Operation	-	-	1
Corporate	1,254	50	881
Consolidated	$ 1,264	$ 64	$ 1,271
Tax Expense			
Personal Insurance Operation	$ 3,225	$ 2,403	$ 432
Commercial Insurance Operation	1,194	569	420
Corporate	(137)	(219)	(827)
Consolidated	$ 4,282	$ 2,753	$ 25
Pre-tax Income			
Personal Insurance Operation	$ 11,647	$ 8,109	$ 1,950
Commercial Insurance Operation	6,651	3,028	1,311
Corporate	(4,830)	(2,535)	(2,575)
Consolidated	$ 13,468	$ 8,602	$ 686

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

9. Segment Information, continued

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

	December 31, 2005	December 31, 2004
Assets		
Personal Insurance Operation	$ 91,625	$ 63,136
Commercial Insurance Operation	112,859	18,557
Corporate	4,422	818
Consolidated	$ 208,906	$ 82,511

10. Earnings Per Share

We have adopted the provisions of SFAS 128 requiring presentation of both basic and diluted earnings per share. A reconciliation of the numerators and denominators of the basic and diluted per share calculations (in thousands, except per share amounts) is presented below:

	2005	2004	2003
Numerator for both basic and diluted earnings per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	$ 9,186	$ 5,849	$ 661
Extraordinary gain	-	-	8,084
Net income	$ 9,186	$ 5,849	$ 8,745
Denominator, basic shares	72,051	42,417	29,151
Effect of dilutive securities:			
Stock options	575	364	408
Denominator, diluted shares	72,626	42,781	29,559
Basic earnings (loss) per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	$ 0.13	$ 0.14	$ 0.02
Extraordinary gain	-	-	0.28
Net income	$ 0.13	$ 0.14	$ 0.30
Diluted earnings (loss) per share:			
Income before cumulative effect of change in accounting principle and extraordinary gain	$ 0.13	$ 0.14	$ 0.02
Extraordinary gain	-	-	0.28
Net income	$ 0.13	$ 0.14	$ 0.30

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

In accordance with SFAS 128, we have restated the basic and diluted weighted average shares outstanding for the twelve months ended December 31, 2004 and 2003 for the effect of a bonus element from our stockholder rights offerings that were successfully completed in 2005 and 2003. According to SFAS 128, there is an assumed bonus element in a rights issue whose exercise price is less than the market value of the stock at the close of the rights offering period. This bonus element is treated as a stock dividend for reporting earnings per share.

11. **Regulatory Capital Restrictions**:

AHIC's 2005, 2004 and 2003 net income (loss) and stockholders' equity (capital and surplus), as determined in accordance with statutory accounting practices, were ($4.6) million, $1.5 million and $2.0 million, and $63.7 million, $11.5 million and $10.0 million, respectively. The minimum statutory capital and surplus required for Hallmark by the Texas Department of Insurance ("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. AHIC did not pay any dividends to Hallmark in 2005. AHIC paid a dividend of $0.2 million in 2004 to Hallmark that was declared in 2003. Based on surplus at December 31, 2005, Hallmark could pay a dividend of up to $6.4 million to Hallmark during 2006 without TDI approval.

PIIC's 2005, 2004 and 2003 net income (loss) and stockholders' equity (capital and surplus), as determined in accordance with statutory accounting practices, were $2.7 million, $3.4 million and ($0.3) million, and $36.2 million, $14.0 million and $10.1 million, respectively. The minimum statutory capital and surplus required for PIIC by 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. Based on net investment income for 2005, the maximum dividend that may be paid by PIIC in 2006 without prior approval of the AZDOI is $1.6 million. PIIC did not pay any dividends to Hallmark during 2005 in order to strengthen policyholders' surplus.

National Association of Insurance Commissioners ("NAIC") requests property/casualty insurers to file a 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. AHIC's 2005, 2004 and 2003 adjusted capital under the RBC calculation exceeded the minimum requirement by 600%, 412% and 186%, respectively. PIIC's 2005, 2004 and 2003 adjusted capital under the RBC calculation exceeded the minimum requirement by 365%, 254% and 117%, respectively.

12. **Stock Compensation Plans**:

We have a stock compensation plan for key employees and non-employee directors, the 2005 Long Term Incentive Plan ("2005 LTIP"), that was approved by the shareholders on May 26, 2005. There are 5,000,000 shares authorized for issuance under the 2005 LTIP and 4,470,000 shares reserved for future issuance as of December 31, 2005. Our 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, 2005, there were incentive stock options to purchase 530,000 shares of our common stock outstanding under the 2005 LTIP, incentive stock options to purchase 636,500 shares outstanding under the Employee Plan and non-qualified stock options to purchase 250,000 shares outstanding under the Director Plan. In addition, as of December 31, 2005, there were outstanding non-qualified stock options to purchase 100,000 shares of our common stock granted to certain non-employee directors outside the Director Plan in lieu of fees for service on our board of directors in 1999. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

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 2005 LTIP and 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, 2005, 2004 and 2003 and the changes during the years ended on those dates is presented below:

	2005		2004		2003	
	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	1,358,500	$0.62	1,263,500	$0.58	2,379,000	$0.50
Granted	530,000	$1.19	475,000	$0.59	205,000	$0.67
Exercised	(364,500)	$0.63	(105,000)	$0.45	(575,000)	$0.39
Forfeited	(7,500)	$0.44	(275,000)	$0.45	(745,500)	$0.49
Outstanding at end of the year	1,516,500	$0.82	1,358,500	$0.62	1,263,500	$0.58
Exercisable at end of the year	473,000	$0.63	744,000	$0.63	1,051,500	$0.56
Weighted average fair value of all options granted		$0.67		$0.34		$0.36

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:

	2005	2004	2003
Expected Term	5.00	5.00	5.00
Expected Volatility	62.50%	67.45%	61.05%
Risk-Free Interest Rate	3.88%	3.12%	2.97%

The following table summarizes information about stock options outstanding at December 31, 2005:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/05	Weighted Avg. Remaining Contractual Actual Life	Weighted Avg. Exercise Price	Number Exercisable at 12/31/05	Weighted Avg. Exercise Price
$ .37 to $ .57	552,500	3.5	$ .51	215,000	$ .42
$ .58 to $ .69	308,000	3.6	$ .66	142,000	$ .67
$ .70 to $ 1.19	656,000	7.9	$ 1.15	116,000	$ .98
$ .37 to $ 1.19	1,516,500	5.4	$ .82	473,000	$ .63

13. Retirement Plans:

Certain employees of the Commercial Insurance Operation 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, 2005, 2004 and 2003 (in thousands) using a measurement date of December 31.

	2005	2004	2003
Assumptions (end of period):			
Discount rate used in determining benefit obligation	5.50%	5.75%	6.00%
Rate of compensation increase	N/A	N/A	N/A
Reconciliation of funded status (end of period):			
Vested benefit obligation	$ (12,936)	$ (13,052)	$ (12,482)
Accumulated benefit obligation	(12,959)	(13,081)	(12,517)
Projected benefit obligation	(12,959)	(13,081)	(12,517)
Fair value of plan assets	10,027	10,901	11,280
Funded status	$ (2,932)	$ (2,180)	$ (1,237)
Unrecognized net obligation	-	-	-
Unrecognized prior service cost	-	-	-
Unrecognized actuarial (gain)/loss	2,847	2,086	887
Prepaid/(accrued) pension cost	$ (85)	$ (94)	$ (350)
Changes in projected benefit obligation:			
Benefit obligation as of beginning of period	$ 13,081	$ 12,517	$ 11,758
Interest cost	724	752	762
Actuarial liability (gain)/loss	352	830	1,085
Benefits paid	(1,198)	(1,018)	(1,088)
Benefit obligation as of end of period	$ 12,959	$ 13,081	$ 12,517

13. **Retirement Plans**, continued:

	2005	2004	2003
Change in plan assets:			
Fair value of plan assets as of beginning of period	$10,901	$11,280	$11,154
Actual return on plan assets (net of expenses)	192	388	1,214
Employer contributions	132	251	-
Benefits paid	(1,198)	(1,018)	(1,088)
Fair value of plan assets as of end of period	$10,027	$10,901	$11,280
Net periodic pension cost:			
Service cost – benefits earned during the period	$ -	$ -	$ -
Interest cost on projected benefit obligation	724	752	762
Expected return on plan assets	(682)	(764)	(749)
Amortizations			
Net obligation/(asset)	-	-	-
Unrecognized prior service cost	-	-	-
Unrecognized (gain)/loss	81	7	-
Net periodic pension cost (credit)	$ 123	$ (5)	$ 13
Discount rate	5.75%	6.00%	6.50%
Expected return on plan assets	6.50%	7.00%	7.00%
Rate of compensation increase	N/A	N/A	N/A

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

2006	$ 966
2007	$ 959
2008	$ 939
2009	$ 920
2010	$ 908
2011-2015	$ 4,463

As of December 31, 2005, the fair value of the plan assets was composed of cash and cash equivalents of $0.2 million, bonds and notes of $3.9 million and equity securities of $5.9 million. 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. We recorded a $2.9 million pension liability at December 31, 2005, of which, $2.8 million was additional minimum pension liability.

Our investment objectives are to preserve capital and to achieve long-term growth through a favorable rate of return equal to or greater than 5% over the long-term (60 yr.) average inflation rate as measured by the consumer price index. We prohibit investments in options, futures, precious metals, short sales and purchase on margin. In 2003, we 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, we consider the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. This resulted in the selection of the 6.5% long-term rate of return on assets assumption. To develop the discount rate used in determining the benefit obligation we used Moody's Aaa corporate bond yields at the measurement date to match the timing and amounts of projected future benefits.

We estimate contributing $0.3 million to the defined benefit cash balance plan during 2006.

The following table shows the weighted-average asset allocation for the defined benefit cash balance plan held as of December 31, 2005 and 2004.

	12/31/05	**12/31/04**
Asset Category:		
Debt securities	39%	41%
Equity securities	59%	57%
Other	2%	2%
Total	100%	100%

We sponsor a defined contribution plan. Under this plan, employees may contribute a portion of their compensation on a tax-deferred basis, and we may contribute a discretionary amount each year. We contributed $0.1 million for each of the twelve months ended December 31, 2005, 2004 and 2003.

14. **Income Taxes**:

The composition of deferred tax assets and liabilities and the related tax effects (in thousands) as of December 31, 2005 and 2004, are as follows:

	2005	2004
Deferred tax liabilities:		
Deferred policy acquisition costs	$ (3,089)	$ (2,715)
Profit sharing commission	(1,033)	(74)
Agency relationship	(211)	(208)
Goodwill	-	(59)
Unrealized holding gains on investments	-	(312)
Fixed asset depreciation	(112)	(131)
Loss reserve discount	(12)	(27)
Other	(97)	(93)
Total deferred tax liabilities	$ (4,554)	$ (3,619)
Deferred tax assets:		
Unearned premiums	$ 2,398	$ 421
Deferred ceding commissions	788	3,182
Pension liability	1,097	806
Net operating loss carry-forward	1,796	1,796
Unrealized holding losses on investments	360	-
Allowance for bad debt	9	189
Unpaid loss and loss adjustment expense	1,064	846
Goodwill	1,502	1,700
Rent reserve	107	126
Investment impairments	201	188
Unearned revenue	67	289
Risk premium reserve	18	42
Other	23	91
Total deferred tax assets	$ 9,430	$ 9,676
Net deferred tax asset before valuation allowance	4,876	6,057
Valuation allowance	884	884
Net deferred tax asset	$ 3,992	$ 5,173

A valuation allowance is provided against our deferred tax asset to the extent that we do 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, 2005 and December 31, 2004. The valuation allowance is provided against a net operating loss carry-forward subject to limitations on its utilization. Based on the evidence available as of December 31, 2005, we believe that it is more likely than not that the remaining net deferred tax assets will be realized. However, this assessment may change during 2006 if our financial results do not meet our current expectations.

14. **Income Taxes**, continued:

A reconciliation of the income tax provisions (in thousands) based on the statutory tax rate to the provision reflected in the consolidated financial statements for the years ended December 31, 2005, 2004 and 2003, is as follows:

	2005	2004	2003
Computed expected income tax expense at statutory regulatory tax rate	$4,579	$2,925	$ 233
Meals and entertainment	6	6	5
Tax exempt interest	(302)	(309)	(122)
Dividends received deduction	(11)	33	(28)
State taxes (net of federal benefit)	158	69	(6)
Other	(148)	29	(57)
Income tax expense	$4,282	$2,753	$ 25
Current income tax expense (benefit)	$2,139	$3,540	($ 89)
Deferred tax expense (benefit)	2,143	(787)	114
Income tax expense	$4,282	$2,753	$ 25

Approximately $0.1 million of the 2005 current income tax provision results from tax deductible goodwill from the PIIC acquisition.

We have available, for federal income tax purposes, unused net operating loss of approximately $5.3 million at December 31, 2005. The losses were acquired as part of the PIIC acquisition and may be used to offset future taxable income. Utilization of the losses is limited under Internal Revenue Code Section 382. Due to this limitation, we believe that $2.6 million of the net operating loss carry-forwards may expire unutilized. Therefore, a valuation allowance of $2.6 million has been established against these net operating loss carry-forwards. The Internal Revenue Code has provided that effective with tax years beginning September 1997, the carry-back and carry-forward periods are 2 years and 20 years, respectively, with respect to newly generated operating losses. The net operating losses (in thousands) will expire, if unused, as follows:

Year	
2021	$ 2,600
2022	2,700
	$ 5,300

15. **Commitments and Contingencies**:

We have several leases, primarily for office facilities and computer equipment, which expire in various years through 2011. Certain of these leases contain renewal options. Rental expense amounted to $1.2 million, $1.2 million and $1.3 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Future minimum lease payments (in thousands) under non-cancelable operating leases as of December 31, 2005 are as follows:

Year	
2006	$ 1,103
2007	1,021
2008	943
2009	390
2010	383
2011 and thereafter	187
Total minimum lease payments	$ 4,027

From time to time, assessments are levied on us by the guaranty association of the State of Texas. Such assessments are made primarily to cover the losses of policyholders of insolvent or rehabilitated insurers. Since these assessments can be recovered through a reduction in future premium taxes paid, we capitalize the assessments as they are paid and amortize the capitalized balance against our premium tax expense. There were no assessments during 2005, 2004 or 2003.

16. **Concentrations of Credit Risk**:

We maintain cash equivalents in accounts with six financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. We monitor the financial stability of the depository institutions regularly and do not believe excessive risk of depository institution failure exists at December 31, 2005.

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

Our reinsurance coverage has historically been provided primarily by Dorinco since July 1, 2000. Effective October 1, 2004, we do not utilize any quota share reinsurance. Our reinsurance recoverable balance at December 31, 2005 is due from three reinsurers.

17. **Subsequent Events**:

On November 14, 2005, we announced the signing of a definitive purchase agreement to acquire all of the issued and outstanding capital stock of Texas General Agency, Inc. and certain affiliated companies for an aggregate cash purchase price of up to $45.6 million, consisting of unconditional consideration of $37.6 million and contingent consideration of $8.0 million. Of the unconditional consideration, $13.9 million was paid at closing and $14.3 million will be paid on or before January 1, 2007 and $9.5 million will be paid on or before January 1, 2008. The payment of any contingent consideration is conditioned on the sellers complying with certain restrictive covenants and TGA achieving certain operational objectives related to premium production and loss ratios. The contingent consideration, if any, will be payable on or before March 30, 2009, unless the sellers elect to defer payment until March 30 of any subsequent year in order to permit further development of the loss ratios. In addition to the purchase price, we will pay $2.0 million to the sellers in consideration of their compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. Of this additional amount, $750 thousand was paid at closing, $750 thousand will be paid on or before January 1, 2007 and $500 thousand will be paid on or before January 1, 2008. This transaction was closed effective January 1, 2006. We have not finalized TGA's purchase price allocation as of the date of this report.

On December 13, 2005, we announced the signing of a definitive agreement to acquire all of the issued and outstanding membership interests in Aerospace Holdings, LLC for an aggregate consideration of up to $15.0 million, consisting of unconditional consideration of $12.5 million due in cash at closing and contingent consideration of up to $2.5 million. The unconditional consideration is allocated $11.9 million to the purchase price and $0.6 million to the seller's compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. The payment of contingent consideration is conditioned on the seller complying with its restrictive covenants and Aerospace achieving certain operational objectives related to premium production and loss ratios. The contingent consideration, if any, will be payable in cash on or before March 30, 2009, unless the seller elects to defer a portion of the payment in order to permit further development of loss ratios. This transaction was also closed effective January 1, 2006. We have not finalized Aerospace's purchase price allocation as of the date of this report.

On January 3, 2006, we executed a promissory note payable to Newcastle Partners, L.P. in the amount of $12.5 million in order to obtain funding to complete the acquisition of Aerospace. The promissory note bears interest at the rate of 10% per annum. The unpaid principal balance of the promissory note, together with all accrued and unpaid interest, is due and payable on demand at any time after June 30, 2006. We intend to retire the promissory note with proceeds from a rights offering to our shareholders during 2006.

On January 27, 2006, we amended and restated the credit agreement with Frost National Bank to a $20.0 million revolving credit facility, with a $5.0 million letter of credit sub-facility. We borrowed $15.0 million under the revolving credit facility to fund the cash required to close the TGA acquisition. Principal outstanding under the revolving credit facility generally bears interest at the three month Eurodollar rate plus 2.00%, payable quarterly in arrears. The amended and restated credit agreement terminates on January 27, 2008.

On January 27, 2006, we issued $25.0 million in subordinated convertible promissory notes to the Opportunity Funds. Each convertible note bears interest at 4% per annum, which rate increases to 10% per annum in the event of default. Interest is payable quarterly in arrears commencing March 31, 2006. Principal and all accrued but unpaid interest is due at maturity on July 27, 2007. Subject to shareholder approval, the convertible notes are convertible by the holders into approximately 19.5 million shares of our common stock (subject to certain anti-dilution provisions), and will be automatically converted to such common stock at maturity.

FINANCIAL STATEMENT SCHEDULES

Unaudited Selected Quarterly Information

	2005				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Total revenue	$17,445	$17,785	$25,167	$26,638	$15,773	$15,650	$15,646	$16,052
Total expense	14,741	14,774	21,516	22,536	13,697	13,454	13,377	13,991
Income before tax	2,704	3,011	3,651	4,102	2,076	2,196	2,269	2,061
Income tax expense	889	1,007	1,178	1,208	664	703	726	660
Net income	$1,815	$2,004	$2,473	$2,894	$1,412	$1,493	$1,543	$1,401
Basic earnings per share[1]:	$0.04	$0.03	$0.03	$0.03	$0.03	$0.04	$0.04	$0.03
Diluted earnings per share[1]:	$0.04	$0.03	$0.03	$0.03	$0.03	$0.03	$0.04	$0.03

1. We issued 50.0 million shares of our common stock during the second quarter of 2005 in connection with our shareholder rights offering. In accordance with SFAS 128, we have restated the basic and diluted weighted average shares outstanding for prior periods for the effect of a bonus element from the rights offering. According to SFAS 128, there is an assumed bonus element in a rights issue whose exercise price is less than the market value of the stock at the close of the rights offering period. This bonus element is treated as a stock dividend for reporting earnings per share.

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

HALLMARK FINANCIAL SERVICES, INC.
BALANCE SHEETS
December 31, 2005 and 2004
(In thousands)

	2005	2004
ASSETS		
Equity securities, available-for-sale, at fair value	$ 986	$ 50
Cash and cash equivalents	1,941	578
Investment in subsidiaries	118,250	36,045
Deferred federal income taxes	969	983
Other assets	1,379	112
	$ 123,525	$ 37,768
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	$ 30,928	$ -
Unpaid losses and loss adjustment expenses	49	114
Current federal income tax payable	467	1,033
Accounts payable and other accrued expenses	6,893	3,965
	38,337	5,112
Stockholders' equity:		
Common stock, $.03 par value, authorized 100,000,000 shares; issued 86,856,610 shares in 2005 and 36,856,610 shares in 2004	2,606	1,106
Capital in excess of par value	62,907	19,647
Retained earnings	22,289	13,103
Accumulated other comprehensive income	(2,597)	(759)
Treasury stock, 14,819 shares in 2005 and 379,319 shares in 2004, at cost	(17)	(441)
Total stockholders' equity	85,188	32,656
	$ 123,525	$ 37,768

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

HALLMARK FINANCIAL SERVICES, INC.
STATEMENT OF OPERATIONS
for the years ended December 31, 2005 and 2004
(In thousands)

	2005	2004
Investment income, net of expenses	$ 61	$ 3
Undistributed share of net earnings in subsidiaries	9,048	6,315
Management fee income	4,830	1,850
Total revenues	13,939	8,168
Losses and loss adjustment expenses	(65)	(106)
Other operating costs and expenses	3,701	2,593
Interest expense	1,254	51
Total expenses	4,890	2,538
Income before income tax	9,049	5,630
Income tax benefit	(137)	(219)
Net income	$ 9,186	$ 5,849

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

HALLMARK FINANCIAL SERVICES, INC.
STATEMENT OF CASH FLOW
For the years ended December 31, 2005 and 2004
(In thousands)

	2005	2004
Cash flows from operating activities:		
Net income	$ 9,186	$ 5,849
Adjustments to reconcile net income to cash used in operating activities:		
Depreciation and amortization expense	16	39
Deferred income tax benefit	14	(914)
Change in unpaid losses and loss adjustment expenses	(65)	(106)
Undistributed share of net (earnings) loss of subsidiaries	(9,048)	(6,315)
Change in current federal income tax payable/recoverable	(566)	1,169
Change in all other liabilities	2,928	(72)
Change in all other assets	(286)	(25)
Net cash provided by (used in) operating activities	2,179	(375)
Cash flows from investing activities:		
Purchases of property and equipment	(30)	(14)
Purchase of equity securities	(928)	-
Capital contributed to insurance company subsidiaries	(75,000)	-
Net cash used in investing activities	(75,958)	(14)
Cash flows from financing activities:		
Proceeds from exercise of employee stock options	230	48
Proceeds from borrowings	30,928	-
Debt issuance costs	(907)	-
Proceeds from rights offering	44,891	
Repayment of borrowings	-	(991)
Net cash used in financing activities	75,142	(943)
Decrease in cash and cash equivalents	1,363	(1,332)
Cash and cash equivalents at beginning of year	578	1,910
Cash and cash equivalents at end of year	$ 1,941	$ 578
Supplemental cash flow information:		
Interest (paid)	$ (1,157)	$ (51)
Income taxes (paid) recovered	$ (415)	$ 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
2005										
Personal Insurance Operation	$ 1,318	$ 16,457	$ 5,762	$ -	$ 37,433	$ 2,283	$ 21,239	$ 11,626	$ 10,839	$ 37,003
Commercial Ins. Operation	7,846	9,815	30,265	-	21,751	1,492	12,610	15,216	30,448	51,249
Corporate	-	49	-	-	-	61	(65)	-	3,701	-
Consolidated	$ 9,164	$ 26,321	$ 36,027	$ -	$ 59,184	$ 3,836	$ 33,784	$ 26,842	$ 44,988	$ 88,252
2004										
Personal Insurance Operation	$ 1,491	$ 19,534	$ 6,192	$ -	$ 32,445	$ 1,372	$ 19,243	$ 10,176	$ 11,881	$ 33,067
Commercial Ins. Operation	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 Gross Amount	Column C Ceded to Other Companies	Column D Assumed From Other Companies	Column E Net Amount	Column F Percentage of Amount Assumed to Net
Year Ended December 31, 2005					
Life insurance in force	$ -	$ -	$ -	$ -	
Premiums					
Life insurance	-	-	-	-	
Accident and health insurance	-	-	-	-	
Property and liability insurance	23,747	448	35,885	59,184	60.6%
Title Insurance	-	-	-	-	
Total premiums	$ 23,747	$ 448	$ 35,885	$ 59,184	60.6%
Year Ended December 31, 2004					
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%

Iallmark Financial Services

ichedule 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
Affiliation With Registrant	Deferred Policy Acquisition Costs	Reserves for Unpaid Claims and Claim Adjustment Expenses	Discount if any, Deducted In Column C	Unearned Premiums	Earned Premiums	Net Investment Income	Claims and Claim Adjustment Expenses Incurred Related to (1) Current Year	(2) Prior Years	Amortization of Deferred Policy Acquisition Costs	Paid Claims and Claims Adjustment Expenses	Premiums Written
a) Consolidated property-casualty Entities											
2005	$ 9,164	$ 26,321	$ -	$ 36,027	$ 59,184	$ 3,836	$ 36,184	$ (2,400)	$ 26,842	$ 25,487	$ 88,252
2004	$ 7,475	$ 19,648	$ -	$ 6,192	$ 32,445	$ 1,386	$ 20,331	$ (1,194)	$ 22,288	$ 22,634	$ 33,067

CORPORATE INFORMATION

BOARD OF DIRECTORS

Mark E. Schwarz
Chairman of the Board & CEO

Scott T. Berlin
Director, Brown, Gibbons, Lang & Company

James H. Graves
Partner, Erwin, Graves & Associates, LP

George R. Manser
Chairman, Concorde Holding Co.

MANAGEMENT TEAM

Mark E. Schwarz
Chairman of the Board & CEO

Mark J. Morrison
President, Chief Operating Officer &
Chief Financial Officer

Kevin T. Kasitz
Executive Vice President & President of Commercial
Insurance Operation

Brookland F. Davis
President of Personal Insurance Operation

Jeffrey R. Passmore
Senior Vice President & Chief Accounting Officer

Richard N. Gibson, FCAS, MAAA
Chief Actuary

Gregory P. Birdsall
Chief Information Officer

CORPORATE HEADQUARTERS

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Ft. Worth, Texas 76102
(817) 348-1600
www.hallmarkgrp.com

INDEPENDENT PUBLIC REGISTERED ACCOUNTANTS

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".

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 9:00 a.m. CDT on May 25, 2006 at 777 Main Street, 11th floor, Ft. Worth, Texas.

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