

AMERICAN SAFETY INSURANCE HOLDINGS LTD  
Form 10-K/A  
March 21, 2007

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

FORM 10-K/A  
Amendment No. 1

Annual Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934  
Transition Report Pursuant To Section 13 Or 15(d) Of The Securities Exchange Act Of 1934

For the fiscal year ended December 31, 2006

Commission file number 1-14795

AMERICAN SAFETY INSURANCE HOLDINGS, LTD.  
(Exact name of registrant as specified in its charter)

Bermuda  
(State of incorporation  
or organization)

Not applicable  
(I.R.S. Employer  
Identification No.)

44 Church Street  
P.O. Box HM 2064  
Hamilton, Bermuda  
(Address of principal executive offices)

HM HX  
(Zip Code)

Registrant's telephone number: (441) 296-8560

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

Title of each class  
Common Stock, \$0.01 par value

Name of each exchange on which registered  
New York Stock Exchange, Inc.

Securities to be 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 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 and (2) 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 contained herein, and will not be contained, to the best of registrant's knowledge, in definitive or information statements incorporated by reference in Part III of this Form 10-K/A or any other document filed with this Form 10-K/A.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer. Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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

The aggregate market value of registrant's voting common stock held by non-affiliates on June 30, 2006 was \$112,097,997. For the purposes of this calculation, shares of common stock of the Registrant held by directors, executive officers and persons who hold more than 5% of the outstanding shares are excluded.

The number of shares of registrant's common stock outstanding on March 9, 2007 was 10,556,449.

Documents Incorporated by Reference: Part III of this Form 10-K/A incorporates by reference information from Registrant's Proxy Statement for the 2007 Annual General Meeting of the Shareholders (the "2007 Proxy Statement").

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## Explanatory Note

This Amendment No. 1 on Form 10-K/A (this Amendment) to our Annual Report on Form 10-K of American Safety Insurance Holdings, Ltd. (the Registrant) for the year ended December 31, 2006 filed on March 15, 2007 (the Original Filing) is being filed solely to change the date in the last line of each of the Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting included in Item 9A of the Original Filing and the Report of Independent Registered Public Accounting Firm included in Item 15 of the Original Filing from March 15, 2007 to March 13, 2007.

As required by Rule 12b-15 promulgated under the Securities and Exchange Act of 1934, as amended, we have included the complete text of Item 8, Item 9A, 9B and Item 15 with no other changes. Also as required by Rule 12 b-15, in connection with this Form 10-K/A the Registrant's Chief Executive Officer and Chief Financial Officer are providing Rule 13a-14(a) certifications dated March 21, 2007 and written statements pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 dated March 21, 2007.

Except as described above, this Amendment does not modify or update disclosure in, or exhibits to, the Original Filing. Furthermore, this amendment does not change any previously reported financial results, nor does it reflect events occurring after the date of the Original Filing.

## Item 8. Financial Statements and Supplementary Data

The Company's consolidated financial statements required under this Item 8 are included as part of Item 15 of this Report.

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

None.

## Item 9A. Controls and Procedures

### Management's Responsibility for Financial Statements

The financial statements presented in this Annual Report have been prepared with integrity and objectivity and are the responsibility of the management of American Safety Insurance Holdings, Ltd. These financial statements have been prepared in conformity with U.S. generally accepted accounting principles and properly reflect certain estimates and judgments based upon the best available information.

The financial statements of the Company have been audited by BDO Seidman LLP, an independent registered public accounting firm. Their accompanying report is based upon an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). The Audit Committee of the Board of Directors, consisting solely of outside directors, meets a minimum of four times a year with the independent registered public accounting firm, the internal auditors and representatives of management to discuss auditing and financial reporting matters. In addition, a meeting is held prior to each quarterly earnings release. The Audit Committee retains the independent registered public accounting firm and regularly reviews the internal accounting controls, the activities of the independent registered public accounting firm and internal auditors and the financial condition of the Company. Both the Company's independent registered public accounting firm and the internal auditors have access to the Audit Committee at any time.

### Evaluation of Disclosure Controls and Procedures

As of December 31, 2006, an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) was carried out on behalf of American Safety Insurance Holdings, Ltd., and its subsidiaries by our management with the participation of our Chief Executive Officer and Chief Financial Officer. Based upon the evaluation, management concluded that these disclosure controls and procedures were effective as of December 31, 2006. *Changes in Internal Controls*

During the fourth quarter of the year ended December 31, 2006, no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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## Item 9B. Other Information

None.

### Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934, as amended. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our evaluation, our management concluded that our internal control over financial reporting was effective as of December 31, 2006. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by BDO Seidman LLP, an independent registered public accounting firm, as stated in its report which is included herein.

/s/ Stephen R. Crim  
Stephen R. Crim  
President and Chief Executive Officer

/s/ William C. Tepe  
William C. Tepe  
Chief Financial Officer

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**Report of Independent Registered Public Accounting Firm on**

**Internal Control Over Financial Reporting**

To the Board of Directors

American Safety Insurance Holdings, Ltd.

We have audited management's assessment in the accompanying Report of Management on Internal Control over Financial Reporting included in Item 9A, that American Safety Insurance Holdings, Ltd. and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006 is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of American Safety Insurance Holdings, Ltd. and subsidiaries as of December 31, 2006 and 2005 and the related consolidated statements of income, changes in shareholders' equity and cash flows and related schedules for each of the three years in the period ended December 31, 2006 and our report dated March 13, 2007 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP

Atlanta, GA  
March 13, 2007

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**SIGNATURES**

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Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on 2007.

AMERICAN SAFETY INSURANCE HOLDING

By: /s/ Stephen R. Crim  
Stephen R. Crim  
President

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### AMERICAN SAFETY INSURANCE HOLDINGS, LTD. AND SUBSIDIARIES

Consolidated Financial Statements

December 31, 2005 and 2006

With Independent Auditors Report Thereon

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#### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors  
American Safety Insurance Holdings, Ltd.

We have audited the accompanying consolidated balance sheets of American Safety Insurance Holdings, Ltd and subsidiaries as of December 31, 2005 and 2006 and the related consolidated statements of operations, shareholders' equity, cash flows and comprehensive income for each of the three years in the period ended December 31, 2006. We have also audited Schedules II, III, and IV as of and for each of the three years in the period ended December 31, 2006. These consolidated financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial 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 financial position of American Safety Insurance Holdings, Ltd. and subsidiaries at December 31, 2005 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related schedules present fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of American Safety Insurance Holdings, Ltd.'s internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 13, 2007 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP

Atlanta, Georgia  
March 13, 2007

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### AMERICAN SAFETY INSURANCE HOLDINGS, LTD. AND SUBSIDIARIES

Consolidated Balance Sheets

Internal Control Over Financial Reporting

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December 31, 2005 and 2006

<u>Assets</u>	<u>2005</u>	<u>2006</u>
Investments:		
Fixed maturity securities available-for-sale, at fair value	\$364,856,826	\$490,031,666
Common stock, at fair value	21,706,103	12,402,957
Preferred stock, at fair value	3,607,000	8,118,060
Short-term investments	<u>25,326,648</u>	<u>40,605,672</u>
Total investments	415,496,577	551,158,355
Cash and cash equivalents	23,289,927	11,293,296
Accrued investment income	4,037,573	4,299,678
Premiums receivable	17,315,778	21,747,908
Ceded unearned premium	28,870,656	35,897,446
Reinsurance recoverable	172,110,582	185,010,493
Deferred income taxes	11,933,791	10,115,869
Deferred policy acquisition costs	10,882,478	12,402,764
Property, plant and equipment, net	4,489,608	5,644,629
Other assets	<u>6,572,007</u>	<u>9,560,230</u>
 Total assets	 \$694,998,977 =====	 \$847,130,668 =====

Liabilities and Shareholders' Equity

Liabilities:		
Unpaid losses and loss adjustment expenses	\$393,493,107	\$439,673,496
Unearned premiums	97,982,908	115,197,804
Ceded premiums payable	16,505,732	25,462,908
Deferred revenues	1,501,741	1,192,705
Accounts payable and accrued expenses	13,066,758	11,810,962
Funds held	11,190,989	16,328,609
Loans payable	37,810,099	38,138,804
Minority interest	<u>5,012,396</u>	<u>3,175,200</u>
Total liabilities	576,563,730	650,980,488
 Shareholders' equity:		
Preferred stock, \$0.01 par value; authorized 5,000,000 shares; no shares issued and outstanding	-	-
Common stock, \$0.01 par value; authorized 15,000,000 shares; issued and outstanding at December 31, 2005 6,753,731 shares, and at December 31, 2006 10,554,200 shares	67,537	105,542
Additional paid-in capital	49,460,019	104,514,200
Retained earnings	70,457,352	90,989,550
Accumulated other comprehensive (loss) income, net	<u>(1,549,661)</u>	<u>540,888</u>
Total shareholders' equity	<u>118,435,247</u>	<u>196,150,180</u>
 Total liabilities and shareholders' equity	 \$694,998,977 =====	 \$847,130,668 =====

See accompanying notes to consolidated financial statements.

AMERICAN SAFETY INSURANCE HOLDINGS, LTD. AND SUBSIDIARIES

Consolidated Statements of Operations

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Years ended December 31, 2004, 2005 and 2006

	<u>2004</u>	<u>2005</u>	
<b>Revenues:</b>			
Direct premiums earned	\$223,052,339	\$229,238,078	\$222
Assumed premiums earned	4,000,601	(81,311)	
Ceded premiums earned	<u>(90,752,226)</u>	<u>(91,576,899)</u>	(75)
Net premiums earned	136,300,714	137,579,868	146
Net investment income	9,772,722	14,315,891	21
Net realized gains (losses)	208,135	(54,101)	1
Real estate income	67,967,125	3,000,078	
Fee Income	210,172	1,196,505	1
Other income	<u>317,784</u>	<u>76,286</u>	
Total revenues	214,776,652	156,114,527	171
<b>Expenses:</b>			
Losses and loss adjustment expenses incurred	93,503,285	84,406,158	92
Acquisition expenses	26,648,980	28,751,979	27
Payroll and related expenses	10,297,037	12,130,136	14
Real estate expenses	55,480,408	2,439,022	
Interest expense	1,075,715	1,257,064	3
Other expenses	8,559,668	11,900,940	12
Minority interest	988,202	515,233	(1)
Expenses recovered from rescission	<u>(229,568)</u>	<u>(1,334,162)</u>	
Total expenses	<u>196,323,727</u>	<u>140,066,370</u>	148
Earnings before income taxes	18,452,925	16,048,157	22
Income taxes	<u>3,695,950</u>	<u>1,391,747</u>	2
Net earnings	\$ 14,756,975	\$14,656,410	\$20
	=====	=====	=====
<b>Net earnings per share:</b>			
Basic	\$2.15	\$2.18	
Diluted	\$2.01	\$2.05	
<b>Weighted average number of shares outstanding</b>			
Basic	<u>6,863,619</u>	<u>6,736,938</u>	8
Diluted	<u>7,342,879</u>	<u>7,163,892</u>	9

See accompanying notes to consolidated financial statements.

## AMERICAN SAFETY INSURANCE HOLDINGS, LTD. AND SUBSIDIARIES

### Consolidated Statements of Shareholders' Equity

Years ended December 31, 2004, 2005 and 2006

	<u>2004</u>	<u>2005</u>	<u>2006</u>
<b>Common stock - number of shares:</b>			
Balance at beginning of period	6,910,766	6,781,721	6,753,731
Issuance of common shares	87,855	173,583	3,800,469
Repurchase of common shares	<u>(219,900)</u>	<u>(201,573)</u>	-
Balance at end of period	6,781,721	6,753,731	10,554,200
	=====	=====	=====
<b>Common stock:</b>			

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Balance at beginning of period	\$69,108	\$67,817	\$67,537
Issuance of common shares	879	1,735	38,005
Repurchase of common shares	<u>(2,170)</u>	<u>(2,015)</u>	<u>-</u>
Balance at end of period	\$67,817	\$67,537	\$105,542
Additional paid-in capital:			
Balance at beginning of period	\$52,744,720	\$51,067,506	\$49,460,019
Issuance of common shares	805,825	1,336,211	54,439,295
Repurchase of common shares	(2,483,039)	(2,943,698)	-
Share based compensation	<u>-</u>	<u>-</u>	<u>614,886</u>
Balance at end of period	\$51,067,506	\$49,460,019	\$104,514,200
Retained earnings:			
Balance at beginning of period	\$41,043,967	\$55,800,942	\$70,457,352
Net earnings	<u>14,756,975</u>	<u>14,656,410</u>	<u>20,532,198</u>
Balance at end of period	\$55,800,942	\$70,457,352	\$90,989,550
Accumulated other comprehensive income:			
Balance at beginning of period	\$1,485,328	\$1,843,418	\$(1,549,661)
Unrealized gain (loss) during the period (net of deferred tax benefit (expense) of \$(65,933), \$783,353, and \$197,928, respectively)	<u>358,090</u>	<u>(3,393,079)</u>	<u>2,090,549</u>
Balance at end of period	<u>\$1,843,418</u>	<u>\$(1,549,661)</u>	<u>\$540,888</u>
Total shareholders' equity	\$108,779,683 =====	\$118,435,247 =====	\$196,150,180 =====

See accompanying notes to consolidated financial statements

AMERICAN SAFETY INSURANCE HOLDINGS, LTD. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2004, 2005 and 2006

	<u>2004</u>	<u>2005</u>
Cash flow from operating activities:		
Net earnings	\$ 14,756,975	\$14,656,410
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Realized (gains) losses on sale of investments	(208,135)	54,101
Depreciation expense	1,174,770	1,116,386
Stock Based Compensation Expense	-	-
Amortization of deferred acquisition costs, net	401,307	855,639
Reinsurance recoverable allowance	-	1,318,000
Amortization of investment premium	2,450,153	2,326,835
Deferred income taxes	1,889,988	(1,509,401)
Change in operating assets and liabilities:		
Accrued investment income	(536,772)	(729,110)
Premiums receivable	6,850,698	3,778,032
Reinsurance recoverable	(18,537,761)	(34,975,997)
Ceded unearned premiums	1,654,444	(3,965,139)
Funds held	3,383,326	2,856,195
Unpaid losses and loss adjustment expenses	91,519,976	72,454,712
Unearned premiums	(6,140,184)	4,901,286
Ceded premiums payable	(5,870,903)	4,653,704
Accounts payable and accrued expenses	1,109,634	(2,303,685)
Deferred revenue	(1,817,775)	1,155,229
Other, net	<u>(2,243,973)</u>	<u>4,246,580</u>



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Net cash provided by operating activities	89,835,768	70,358,811
Cash flow from investing activities:		
Purchase of fixed maturities	(107,194,605)	(150,861,495)
Purchase of common stock	(12,854,116)	(7,106,043)
Purchase of preferred stocks	-	(3,500,900)
Proceeds from sales of fixed maturities	27,752,791	3,584,528
Proceeds from matured securities	4,420,000	60,635,000
Proceeds from sales of equity securities	1,380,010	1,195,954
Decrease (increase) in short-term investments	(20,217,314)	571,483
Decrease in notes receivable	1,435,000	-
Decrease of investment in real estate	35,850,109	2,005,440
Purchases of fixed assets	<u>(980,480)</u>	<u>(1,705,521)</u>
Net cash used in investing activities	(70,408,605)	(95,181,554)

	<u>2004</u>	<u>2005</u>
Cash flow from financing activities:		
Proceeds from sale of common stock	638,495	1,218,455
Stock repurchase payments	(2,485,209)	(2,945,714)
Proceeds from (repayment of) loan payable	(17,421,859)	24,996,193
Proceeds from redemption of escrow deposits	(9,091,347)	(144,500)
Withdrawals from restricted cash, net	<u>1,623,114</u>	<u>144,500</u>
Net cash (used in) provided by financing activities	<u>(26,736,806)</u>	<u>23,268,934</u>
Net decrease in cash	(7,309,643)	(1,553,809)
Cash and cash equivalents at beginning of period	<u>32,153,379</u>	<u>24,843,736</u>
Cash and cash equivalents at end of period	\$24,843,736 =====	\$23,289,927 =====
Supplemental disclosure of cash flow:		
Income taxes paid	\$ 3,525,270 =====	\$287,617 =====
Interest paid	\$ 1,121,713 =====	\$983,195 =====

See accompanying notes to consolidated financial statements.

AMERICAN SAFETY INSURANCE HOLDINGS, LTD. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

Years ended December 31, 2004, 2005 and 2006

	<u>2004</u>	<u>2005</u>
Net earnings	\$14,756,975	\$14,656,410
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available-for sale, net of minority interest of \$(108,334), \$(259,129) and \$11,815 for 2004, 2005 and 2006, respectively	463,260	(4,541,890)
Unrealized gains (losses) on hedging transactions	81,912	311,359
Reclassification adjustment for realized (gains) losses included in net earnings, net of minority		

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interest of \$(86,986), \$(0) and \$(25,530) for 2004, 2005 and 2006 respectively.	<u>(121,149)</u>	<u>54,101</u>
Total other comprehensive income (loss) before income taxes	424,023	(4,176,430)
Income tax expense (benefit) related to items of other comprehensive income, net of minority interest of \$0 for 2004, \$(5,534) for 2005 and \$9,071 for 2006 respectively.	<u>65,933</u>	<u>(783,351)</u>
Other comprehensive income (loss)	<u>358,090</u>	<u>(3,393,079)</u>
Total comprehensive income	\$15,115,065 =====	\$11,263,331 =====

See accompanying notes to consolidated financial statements.

## AMERICAN SAFETY INSURANCE HOLDINGS, LTD. AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

**December 31, 2005 and 2006**

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying consolidated financial statements of American Safety Insurance Holdings, Ltd. ( American Safety ) and its subsidiaries and American Safety Risk Retention Group Inc. ( American Safety RRG ), a non-subsidiary risk retention group affiliate (collectively, the Company ) are prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ). The preparation of financial statements in conformity with GAAP requires management to make estimates, based on the best information available, in recording transactions resulting from business operations. The balance sheet amounts that involve a greater extent of accounting estimates and/or actuarial determinations subject to future changes are the Company's invested assets, deferred income taxes, and the liabilities for unpaid losses and loss adjustment expenses. As additional information becomes available (or actual amounts are determinable), the recorded estimates may be revised and reflected in operating results. While management believes that these estimates are adequate, such estimates may change in the future.

(b) Description of Common Stock Voting and Ownership Rights

The authorized share capital of the Company is 20 million shares, consisting of 15 million common shares, par value \$.01 per share ( Common Shares ), and 5 million preferred shares, par value \$.01 per share ( Preferred Shares ). The Common Shares are validly issued, fully paid, and non-assessable. There are no provisions of Bermuda law or the Company's Bye-Laws which impose any limitations on the rights of shareholders to hold or vote Common Shares by reason of such shareholders not being residents of Bermuda. Holders of Common Shares are entitled to receive dividends ratably when and as declared by the Board of Directors out of funds legally available therefore.

Each holder of Common Shares is entitled to one vote per share on all matters submitted to a vote of the Company's shareholders, subject to the 9.5% voting limitation described below. All matters, including the election of directors, voted upon at any duly held shareholders meeting shall be authorized by a majority of the votes cast at the meeting by shareholders represented in person or by proxy, except (i) approval of a merger, consolidation or amalgamation; (ii) the sale, lease, or exchange of all or substantially all of the assets of the Company; and (iii) amendment of certain provisions of the Bye-Laws, which each require the approval of at least 66-2/3% of the outstanding voting shares (in addition to any regulatory or court approvals). The Common Shares have non cumulative voting rights, which means that the holders of a majority of the Common Shares may elect all of the directors of the Company and, in such event, the holders of the remaining shares will not be able to elect any directors.

The Bye-Laws contain certain provisions that limit the voting rights that may be exercised by certain holders of Common Shares. The Bye-Laws provide that each holder of Common Shares is entitled to one vote per share on all matters submitted to a vote of the Company's shareholders, except that if, and so long as, the Controlled Shares (as defined below) of any person constitute 9.5% or more of the issued and outstanding Common Shares, the voting rights with respect to the Controlled Shares owned by such person shall be limited, in the aggregate, to a voting power of 9.5%, other than the voting rights of Frederick C. Treadway or Treadway Associates, L.P., affiliates of a founding shareholder of the Company. Controlled Shares mean (i) all shares of the Company directly, indirectly, or constructively owned by any person and (ii) all shares of the Company directly, indirectly, or beneficially owned by such person within the meaning of Section 13(d) of the Exchange Act (including any shares owned by a group of persons, as so defined and including any shares that would otherwise be excluded by the provisions of Section 13(d)(6) of the Exchange Act). Under these provisions, if, and so long as, any person directly, indirectly, or constructively owns Controlled Shares having more than 9.5% of the total number of votes exercisable in respect of all shares of voting stock of the Company, the voting rights attributable to such shares will be limited, in the aggregate, to 9.5% of the total number of votes.

No holder of Common Shares of the Company shall, by reason only of such holder, have any preemptive right to subscribe to any additional issue of shares of any class or series nor to any security convertible into such shares.

(c) Principles of Consolidation

The consolidated financial statements include the accounts of American Safety Insurance Holdings, Ltd., a Bermuda company, American Safety Reinsurance, Ltd. (American Safety Re), American Safety Assurance Ltd., (ASA) two 100%-owned licensed Bermuda insurance companies, American Safety Holdings Corp. (American Safety Holdings), a 100%-owned insurance holding company and American Safety Risk Retention Group, Inc. (American Safety RRG), a non-subsidiary risk retention group affiliate. American Safety Holdings in turn wholly owns American Safety Casualty Insurance Company (American Safety Casualty), a property and casualty insurance company, American Safety Insurance Services, Inc. (ASI Services), an underwriting and administrative subsidiary, Ponce Lighthouse Properties, Inc. (CityPonce), the development company of the Harbour Village project, and Rivermar Contracting Company (Rivermar), the general contractor of the Harbour Village project. American Safety Casualty owns 88% of American Safety Indemnity Company, a property and casualty excess and surplus lines insurance company. The remaining 12% is owed by American Safety Holdings. ASI Services wholly owns the following subsidiaries: Sureco Bond Services, Inc. (Sureco), a bonding agency; Environmental Claims Services, Inc. (ECSI), a claims service firm; American Safety Financial Corp., a financial services subsidiary; and American Safety Purchasing Group, Inc., which acts as a purchasing group for the placement of certain business with American Safety Casualty.

In accordance with FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities (VIEs) and FASB Interpretation No. 46 Revised (FIN 46R), the accompanying financial statements consolidate American Safety RRG, based on its status as VIE and the Company's status as the primary beneficiary of the VIE. A minority interest has been established for the equity holders of American Safety RRG. The accompanying financial statements also de-consolidate American Safety Capital Trust, American Safety Capital Trust II and American Safety Capital Trust III (American Safety Capital, American Safety Capital II and American Safety Capital III, respectively) based on their status as variable interest special purpose

entities of the Company's status as not being the primary beneficiary. American Safety Capital, American Safety Capital II and American Safety Capital III are accounted for under the equity method.

All significant intercompany balances have been eliminated, as appropriate, in consolidation.

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(d) Business Environment

The following is a description of certain risks facing the Company and its subsidiaries:

Legal/Regulatory Risk is the risk that changes in the legal or regulatory environment in which an insurer operates will create additional expenses not anticipated by the insurer in pricing its products and beyond those recorded in the financial statements. That is, regulatory initiatives designed to reduce insurer profits or otherwise affecting the industry in which the insurer operates, new legal theories or insurance company insolvencies through guaranty fund assessments, may create costs for the insurer beyond those recorded in the financial statements. The Company attempts to mitigate this risk by actively writing insurance business in several states, thereby spreading this risk over a large geographic area.

The Potential Risk of country-regionUnited States Taxation of Bermuda Operations. Under current Bermuda law, American Safety is not required to pay any taxes in Bermuda on either income or capital gains. American Safety has received an undertaking from the Minister of Finance in Bermuda that will exempt American Safety from taxation until the year 2016 in the event of any such taxes being imposed. Whether a foreign corporation is engaged in a country-regionUnited States trade or business or is carrying on an insurance business in the country-regionUnited States depends upon the level of activities conducted in the United States. If the activities of a foreign company are continuous, regular, and considerable, the foreign company will be deemed to be engaged in a United States trade or business. Due to the fact that American Safety will continue to maintain an office in Bermuda and American Safety's, American Safety Re's and American Safety Assurance's sole business is reinsuring contracts via treaty reinsurance agreements, which are all signed outside of the United States, American Safety does not consider itself to be engaged in a trade or business in the United States and, accordingly, does not expect to be subject to United States income taxes. This position is consistent with the position taken by various other entities that have similar operational structures as American Safety.

However, because the Internal Revenue Code of 1986, as amended, the Treasury Regulations and court decisions do not definitively identify activities that constitute being engaged in a United States trade or business, and because of the factual nature of the determination, there can be no assurance that the Internal Revenue Service will not contend that American Safety or its Bermuda insurance subsidiary are engaged in a United States trade or business. In general, if American Safety or its Bermuda insurance subsidiaries are considered to be engaged in a United States trade or business, it would be subject to (i) United States Federal income tax on its taxable income that is effectively connected with a United States trade or business at graduated rates and (ii) the 30 percent branch profits tax on its effectively connected earnings and profits deemed repatriated from the United States. Certain subsidiaries of American Safety are, however, subject to U.S. Federal and state income tax, as they are domiciled and conduct business in the United States.

Credit Risk is the risk that issuers of securities owned by the insurer or secured notes receivable will default or that other parties, including reinsurers that have obligations to the insurer, will not pay or perform. The Company attempts to mitigate this risk by adhering to a conservative investment strategy, by obtaining sufficient collateral for secured note obligations and by maintaining sound reinsurance, credit and collection policies.

Interest Rate Risk is the risk that interest rates will change and cause a decrease in the value of an insurer's investments. The Company attempts to mitigate this risk by attempting to match the maturities of its assets with the expected payouts of its liabilities.

(e) Investments

Fixed maturity securities for which the Company has the positive intent and ability to hold to maturity are classified as held to maturity and are reported at amortized cost. Fixed maturity and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading and are reported at fair value, with unrealized gains and losses included in earnings. Fixed maturity and equity securities not classified as either held to maturity or trading are classified as available for sale and are reported at fair value, with unrealized gains and losses (net of deferred taxes) charged or credited as a component of accumulated other comprehensive income.

While it is the Company's intent to hold fixed maturity securities until the foreseeable future or until maturity, it may sell such securities in response to, among other things, market conditions, liquidity needs, or interest rate fluctuations. At December 31, 2005 and 2006, the Company considered all of its fixed maturity securities as available for sale.

The Company notes that it has the ability and intent to hold securities with unrealized losses until they mature or recover in value. However, all investment securities are characterized as available for sale, and the Company may, from time to time, sell securities in response to market conditions or interest rate fluctuations in accordance with its investment guidelines or to fund the cash needs of individual operating subsidiaries. When a decision is made to sell a security that has an unrealized loss, the loss is recognized at the time of the decision.

Investment income is recorded as earned on the accrual basis and includes amortization of premiums and accretion of discounts using the interest method. Realized gains or losses on disposal of investments are determined on a specific identification basis and are included in revenues. Investments in real estate are carried at the lower of cost or fair value plus capitalized development costs. Premiums and discounts arising from the purchase of mortgage-backed securities are treated as yield adjustments over their estimated lives. The Company's portfolio managers routinely monitor and evaluate the difference between the cost and fair value of our investments. Additionally, credit analysis and/or credit rating issues related to specific investments may trigger more intensive monitoring to determine if a decline in market value is other than temporary. For investments with a market value below cost, the process includes evaluating the length of time and the extent to which cost exceeds market value, the prospects and financial condition of the issuer, and evaluation for a potential recovery in market value, among other factors. This process is not exact and further requires consideration of risks such as credit risk, which to a certain extent can be controlled, and interest rate risk, which cannot be controlled. Therefore, if an investment's cost exceeds its market value solely due to changes in interest rates, impairment may not be appropriate. If, after monitoring and analysis, the Company believes that a decline in fair value is other than temporary, the Company adjusts the amortized cost of the security and reports a realized loss in the consolidated statements of earnings.

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(f) Recognition of Premium Income

General liability premiums are primarily estimated based upon the annual revenues of the underlying insureds. Additional or return premiums are recognized for differences between provisional premiums billed and estimated ultimate general liability premiums due when the final audit is complete after the policy has expired. General liability, surety, commercial auto, other commercial lines and workers' compensation premiums are recorded ratably over the policy period with unearned premium calculated on a pro rata basis over the lives of the underlying coverages.

(g) Deferred Policy Acquisition Costs

The costs of acquiring business, primarily commissions and premium tax expenses, are deferred (to the extent they are recoverable from future premium income) and amortized to earnings in relation to the amount of premiums earned. If necessary, investment income is considered in the determination of the recoverability of deferred policy acquisition costs. Deferred revenue results when reinsurance ceding commissions received exceed the related deferred acquisition costs for direct and assumed business.

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An analysis of deferred policy acquisition costs follows:

	Years ended December 31,		
	2004	2005	2006
Balance, beginning of period	\$ 12,006,478	\$ 11,738,117	\$ 10,882,4
Acquisition costs deferred, net	26,380,619	27,725,425	28,982,8
Costs amortized during the period	<u>(26,648,980)</u>	<u>(28,581,064)</u>	<u>(27,462,5</u>
Balance, end of period	\$11,738,117 =====	\$ 10,882,478 =====	\$12,402,76 =====

### (h) Unpaid Losses and Loss Adjustment Expenses

The Company provides a liability for unpaid losses and loss adjustment expenses based upon aggregate case estimates for reported claims and estimates for incurred but not reported losses. Because of the length of time required for the ultimate liability for losses and loss adjustment expenses to be determined for certain lines of business underwritten, the Company has limited experience upon which to base an estimate of the ultimate liability. For these lines, management has established loss and loss adjustment expense reserves based on actuarial methods that determine ultimate losses and loss adjustment expenses utilizing a combination of both industry and the Company's reporting and settlement patterns, as appropriate. One primary set of actuarial methods utilized, Bornhuetter-Ferguson, entails developing an initial expected loss ratio based upon gross ultimate losses from prior accident years, estimating the portion of ultimate losses expected to be reported and unreported, and adding the actual reported losses to the expected unreported losses to derive the indicated ultimate losses. However, the net amounts that will ultimately be paid to settle the liability may be more or less than the estimated amounts provided.

### (i) Income Taxes

For subsidiaries subject to taxation, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. When the Company does not believe that, on the basis of available information, it is more likely than not deferred tax assets will be recovered it recognizes a valuation allowance against its deferred tax assets.

### (j) Reinsurance

Reinsurance contracts do not relieve the Company from its obligation to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company. The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk to minimize its exposure to significant losses from reinsurer insolvencies. Reinsurance recoverables on unpaid losses and prepaid reinsurance represent amounts recoverable from reinsurers for unpaid losses and unearned ceded reinsurance premiums, respectively.

### (k) Goodwill and Intangibles

The Company adopted SFAS 142 on January 1, 2002. Under SFAS 142, goodwill and indefinite-lived intangible assets are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Prior to

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adoption, the Company amortized goodwill over a 20 year period. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives (but with no maximum life).

At December 31, 2005 and 2006, the Company had \$1,467,000 of goodwill.

In accordance with the disclosure requirements of SFAS 142 goodwill and intangibles there was no amortization recorded in net income for the years ended December 31, 2004, 2005 and 2006 respectively.

### (l) Net Earnings Per Share

Basic earnings per share and diluted earnings per share are computed by dividing net earnings by the weighted average number of shares outstanding for the period (basic EPS) plus dilutive shares attributable to stock options (diluted EPS).

Earnings per share are as follows:

	<u>2004</u>	<u>2005</u>
Weighted average shares outstanding	6,863,619	6,736,938
Shares attributable to stock options	<u>479,260</u>	<u>426,954</u>
Weighted average common and common equivalents	7,342,879	7,163,892
	=====	=====
Earnings per share:		
Basic	\$2.15	\$ 2.18
Diluted	\$ 2.01	\$ 2.05

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### (m) Employee Stock Options

The Company's stock option plan grants stock options to employees. The majority of the options outstanding under the plan generally vest evenly over a three year period and have a term of 10 years. The Company uses the Black-Scholes option pricing model to value stock options. This plan is described further in Note 13.

The Company applied the recognition and measurement principles of SFAS No. 123R, Share Based Payments under modified prospective application method, commencing in the first quarter of 2006. Compensation expense relating to stock options of \$614,886 is reflected in earnings for the twelve months ended December 31, 2006.

### (n) Accounting Pronouncements

During the last two years, the Financial Accounting Standard Board (FASB) has issued a number of accounting pronouncements with various effective dates.

In November 2005, the FASB issued Staff Position Number FAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments ( FSP 115-1 ). FSP 115-1 addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in FSP 115-1 amends FASB Statement No. 115, Accounting for Certain Investments in Debt

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and Equity Securities, and was effective January 1, 2006. The adoption of this pronouncement did not have a material impact on the Company's financial statements.

In April 2006, the FASB issued a Staff Position Number FIN 46(R)-6, Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R) ( FSP 46R-6 ).

FSP 46R-6 responds to the need for guidance on the relevant risks and rewards that must be identified and evaluated in order to apply FIN 46(R) and is effective for fiscal periods beginning after June 15, 2006. This pronouncement will have no impact on the Company as it already consolidates its non-subsidiary affiliate American Safety RRG.

In July 2006, the FASB issued a Staff Position Number FIN 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB statement number 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company has reviewed the pronouncement and, based on its analysis to date does not expect it to have a material impact on its operating results.

In September 2006, the FASB issued Statement Number 157, Fair Value Measurements. Prior to this statement, there were different definitions of fair value in GAAP. Moreover, that guidance was dispersed among the many accounting pronouncements that require fair value measurements. This statement creates a single set of guidelines for measuring fair value. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. At the present time it is expected that this statement will not have a material impact on the Company's financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. The Company does not believe SAB 108 will have a material impact on the Company's financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards Number 159, The Fair Value Option For Financial Assets and Liabilities. This statement allows companies to carry the vast majority of financial assets and liabilities at fair value, with changes in fair value recorded into earnings. This statement is effective for fiscal years beginning after November 15, 2007. The Company expects that this statement will not have a material impact on the Company's financial statements.

### (o) Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, money market instruments and other debt instruments with a maturity of 90 days or less when purchased.

### (p) Derivatives

The Company has limited activity with derivative financial instruments. They are not used for trading purposes, nor does the Company engage in leveraged derivative transactions. At December 31, 2006, the Company's outstanding derivative contracts were interest swaps related to certain of its trust preferred obligations. See Note 8. The Company recognizes unrealized gain or loss on these interest rate swaps as interest rates change. The net after tax derivative loss included in accumulated other comprehensive income at December 31, 2006 will be reclassified into interest expense in conjunction with the recognition of interest payments on trust preferred debt through October 2010, with \$186,000 of after tax net loss expected to be recognized in interest expense within the next year.



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(q) Reclassifications

Certain items in the prior periods' financial statements have been reclassified to conform to the 2006 presentation. In 2006 the Company changed its segment presentation. See Note 10 for additional information.

(2) Investments

Net investment income is summarized as follows:

	<u>2004</u>	<u>Years ended December 31,</u> <u>2005</u>
Fixed maturities	\$ 9,695,664	\$ 13,567,965
Common stock securities	195,009	367,697
Preferred stock securities	-	23,149
Short-term investments and cash	<u>298,305</u>	<u>914,171</u>
	10,188,978	14,872,982
Less investment expenses	<u>416,256</u>	<u>557,091</u>
Net investment income	\$9,772,722 =====	\$14,315,891 =====

Realized and unrealized gains and losses were as follows:

	<u>2004</u>	<u>Years ended December 31,</u> <u>2005</u>	<u>2006</u>
Realized gains:			
Fixed maturities	\$ 182,336	\$ 91,077	\$ 1,175
Common stock securities	<u>118,952</u>	<u>154,906</u>	<u>2,789</u>
Total gains	<u>301,288</u>	<u>245,983</u>	<u>3,965</u>
Realized losses:			
Fixed maturities	(66,977)	(250,383)	(2,223)
Common stock securities	<u>(26,176)</u>	<u>(49,701)</u>	<u>(552)</u>
Total losses	<u>(93,153)</u>	<u>(300,084)</u>	<u>(2,775)</u>
Net realized gains (losses)	\$ 208,135 =====	\$ (54,101) =====	\$ 1,190 =====
Changes in unrealized gains (losses):			
Fixed maturities	\$ (758,834)	\$ (5,496,515)	\$ 1,886
Common stock securities	905,625	643,499	421
Preferred stock securities	<u>-</u>	<u>106,100</u>	<u>105</u>
Net change in unrealized gains (losses)	\$ 146,791 =====	\$ (4,746,916) =====	\$ 2,412 =====

At December 31, 2005 and 2006, the Company did not hold fixed-maturity securities, which individually exceeded 10% of shareholders' equity, except U.S. government, and government agency securities.

The amortized cost and estimated fair values of investments at December 31, 2005 and 2006 are as follows:

Amortized	Gross unrealized	Gross unrealized
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December 31, 2005 and 2006

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	Cost =====	gains =====	losses =====
December 31, 2005			
Fixed maturities:			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies States of the U.S. and political subdivisions of the states	\$ 86,740,033  64,740,408	\$ 547,669  386,303	\$1,311,628  498,465
Corporate securities	84,763,525	618,765	1,598,413
Mortgage-backed securities	<u>132,992,335</u>	<u>56,265</u>	<u>2,579,971</u>
Total fixed maturities	\$369,236,301 =====	\$ 1,609,002 =====	\$ 5,988,477 =====
Common stock	\$ 19,983,174 =====	\$ 2,721,304 =====	\$ 998,374 =====
Preferred Stock	\$ 3,500,900 =====	\$ 106,100 =====	\$ - =====
December 31, 2006			
Fixed maturities:			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies States of the U.S. and political subdivisions of the states	\$ <u>123,390,583</u>  7,584,447	\$ <u>386,236</u>  42,338	\$ <u>1,378,807</u>  238,041
Corporate securities	131,469,859	814,574	812,477
Mortgage-backed securities	230,080,072	731,214	2,020,332
Total fixed maturities	\$ 492,524,961 =====	\$ 1,956,362 =====	\$ 4,449,657 =====
Common stock	\$ 10,258,638 =====	\$ 2,491,431 =====	\$ 347,112 =====
Preferred stock	\$ 7,906,620 =====	\$ 221,830 =====	\$ 10,390 =====

The amortized cost and estimated fair values of fixed maturities at December 31, 2006 by contractual maturity are shown below. Expected maturities may differ from contractual maturities as certain borrowers may have the right to call or prepay obligations with or without call or prepayment penalty.

	Amortized <u>cost</u>	Estimated <u>fair value</u>
Due in one year or less	\$ 27,439,286	\$ 27,425,880
Due after one year through five years	148,763,529	148,254,566
Due after five years through ten years	75,799,419	74,842,208
Due after ten years	10,442,655	10,718,058
Mortgage-backed securities	<u>230,080,072</u>	<u>228,790,954</u>
Total	\$492,524,961 =====	\$490,031,666 =====

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Fixed income securities with an amortized cost of \$34,405,204 and \$26,694,924 were on deposit with insurance regulatory authorities at December 31, 2005 and 2006 in accordance with statutory requirements.

The fair value of the investments in debt securities can fluctuate greatly as a result of changes in interest rates. The Company believes that the declines in fair value noted below primarily resulted from changes in interest rates rather than credit issues. (See Critical Accounting Policies under Part II, Item 7 for more information on investments)

Therefore, the Company has no concern regarding the ultimate collectibility of the security value, and accordingly, has not recorded any impairment write-down. The tables below show the securities the Company is holding which have been held at a loss for less than 12 months and greater than 12 months at December 31, 2005 and December 31, 2006 respectively.

December 31, 2005

	Less than 12 months Fair Value	Unrealized Losses	12 months or longer Fair Value	Unrealized Losses	Fa
US Treasury Securities & other government corporations and agencies	\$39,303,992	\$ (546,902)	\$25,829,191	\$ (764,727)	\$
States of the US and political subdivisions of the states	27,795,435	(329,164)	5,921,758	(169,302)	
Corporate securities	30,765,595	(614,456)	34,496,894	(983,957)	
Mortgage-backed securities	<u>85,185,338</u>	<u>(1,360,455)</u>	<u>34,261,657</u>	<u>(1,219,516)</u>	<u>1</u>
Subtotal, fixed maturities	183,050,361	(2,850,976)	100,509,500	(3,137,501)	2
Common stock	<u>4,590,179</u>	<u>(502,397)</u>	<u>1,994,090</u>	<u>(495,977)</u>	<u>---</u>
Total temporarily impaired securities	<u>\$187,640,540</u>	<u>\$ (3,353,372)</u>	<u>\$102,503,590</u>	<u>\$ (3,633,479)</u>	<u>\$29</u>

December 31, 2006

	Less than 12 months Fair Value	Unrealized Losses	12 months or longer Fair Value	Unrealized Losses	Fa
US Treasury Securities & other government corporations and agencies	\$53,077,690	\$ (218,138)	\$36,967,250	\$ (1,160,669)	\$9
States of the US and political subdivisions of the states	-	-	6,409,615	(238,041)	
Corporate securities	59,749,175	(412,465)	20,291,277	(400,012)	8
Mortgage-backed securities	<u>95,741,114</u>	<u>(466,246)</u>	<u>67,439,424</u>	<u>(1,554,086)</u>	<u>16</u>
Subtotal, fixed maturities	208,567,979	(1,096,849)	131,107,566	(3,352,808)	33
Common stock	913,738	(103,126)	1,091,057	(243,986)	

Preferred Stock	<u>1,467,260</u>	<u>(10,390)</u>	<u>—</u>	<u>—</u>
Total temporarily impaired securities	\$210,948,977 =====	\$ (1,210,365) =====	\$132,198,623 =====	\$ (3,596,794) \$34 =====

(3) Investment in Real Estate

The Company's investment in real estate is known as Harbour Village Golf and Yacht Club ( Harbour Village ) comprised of 173 acres of property in Ponce Inlet, StateFlorida that was acquired in foreclosure during April 1999. At the date of foreclosure the Company evaluated the carrying value of its investment in real estate by comparing the fair value of the foreclosed collateral to the book value of the underlying loan and accrued interest. As the book value of the loan and accrued interest was less than the fair value of the collateral, no loss was recognized on foreclosure and the book balance of the loan and accrued interest became the basis of the real estate.

The Harbour Village project is substantially complete as all units are sold and closed. The Company does not expect to engage in any further real estate activities. No additional revenue from Harbour Village is expected. There will be some ongoing expenses for the project associated with legal, insurance and other matters.

(4) Financial Instruments

The carrying amounts for short-term investments, cash, premiums receivable, commissions receivable, accrued investment income, ceded premiums payable, funds held, collateral held and accounts payable and accrued expenses approximate their fair values due to the short-term nature of these instruments and obligations.

Estimated fair values for fixed maturities were provided by outside consultants using market quotations, prices provided by market makers or estimates of fair values obtained from yield data relating to investment securities with similar characteristics.

(5) Reinsurance

**Excess and Surplus Lines**

*Environmental*

The Company has excess of loss reinsurance treaties with various reinsurers for the Company's general liability line of business. These treaties provide varying levels of reinsurance protection depending on the date the underlying insurance policy was written.

*Construction*

The Company previously had excess of loss treaties with various reinsurers for the Company's construction line of business. These treaties provide varying levels of reinsurance protection depending on the date the underlying insurance policy was written.

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Effective July 1, 2005, the Company discontinued purchasing excess of loss reinsurance on our construction line. The Company made this decision after performing a loss cost and dynamic financial analysis and concluding that our reinsurance purchases were uneconomical. The Company believes that based upon reinsurance market pricing at the time of the decision, retaining this exposure and not ceding a large percentage of premiums to the reinsurance market will enhance our balance sheet.

### *Surety*

For our surety business, we entered into a quota share reinsurance treaty during the second quarter of 2004 which provides reinsurance for a single bond limit not to exceed \$3.0 million, subject to a maximum for any one principal of \$6.0 million. We retained a 50% participation in this treaty with the balance reinsured by unaffiliated reinsurers. Effective June 1, 2006 this treaty was non-renewed.

## **Alternative Risk Transfer**

### *Specialty Programs*

The Company's program business division buys various forms of reinsurance on both a quota share basis as well as an excess of loss basis. These treaties cover the majority of risks written by the Company in this division. In addition, we require our program managers to share in the underwriting risks on many of our programs. Where appropriate, collateral is obtained from the reinsurers and program managers to secure their obligations.

## **Runoff**

### *Workers Compensation*

The Company has excess of loss treaties with various reinsurers. These treaties provide varying levels of reinsurance protection depending on the date the underlying insurance policy was written.

The approximate effects of reinsurance on the financial statement accounts listed below are as follows:

	Years ended December 31,		
	2004	2005	2006
	-----		
	(In thousands)		
Written premiums:			
Direct	\$220,452	\$ 234,139	\$ 239,472
Assumed	(158)	(81)	135
Ceded	<u>(88,630)</u>	<u>(95,543)</u>	<u>(82,339)</u>
Net	\$ 131,664	\$ 138,515	\$ 157,268
	=====	=====	=====
Earned premiums:			
Direct	\$ 223,052	\$229,238	\$222,257
Assumed	4,000	(81)	135
Ceded	<u>(90,751)</u>	<u>(91,577)</u>	<u>(75,636)</u>

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Net	\$ 136,301	\$ 137,580	\$ 146,756
	=====	=====	=====
Losses and loss adjustment expenses incurred			
Direct	\$ 153,167	\$ 159,668	\$ 159,920
Assumed	4,379	2,031	-
Ceded	<u>(64,043)</u>	<u>(77,293)</u>	<u>(67,591)</u>
Net	\$ 93,503	\$ 84,406	\$ 92,329
	=====	=====	=====
Unpaid loss and loss adjustment expenses:			
Direct	\$ 306,600	\$ 377,952	\$ 425,342
Assumed	14,438	15,541	14,331
Ceded	<u>(136,998)</u>	<u>(159,515)</u>	<u>(161,146)</u>
Net	\$ 184,040	\$ 233,978	\$ 278,527
	=====	=====	=====

(6) Income Taxes

Total income tax expense for the years ended December 31, 2004, 2005 and 2006 was allocated as follows:

	<u>2004</u>	<u>2005</u>
Tax expense attributable to:		
income from continuing operations	\$ 3,695,950	\$ 1,391,747
Unrealized gain on hedging transactions	27,851	105,861
Unrealized gain (losses) on securities available-for-sale	<u>38,082</u>	<u>(894,746)</u>
Total	\$3,761,883	\$ 602,862
	=====	=====

U.S. Federal and state income tax expense (benefit) from continuing operations consists of following components:

	<u>2004</u>	<u>2005</u>
Current	\$ 2,300,361	\$ 3,455,663
Deferred	1,889,988	(1,509,401)
(Reversal) Establishment of valuation allowance	<u>(494,399)</u>	<u>(554,515)</u>
Total	\$3,695,950	\$1,391,747
	=====	=====

The state income tax components aggregated \$677,840, \$307,485 and \$(17,825) for the years ended December 31, 2004, 2005 and 2006, respectively.

Income tax expense from continuing operations for the years ended December 31, 2004, 2005 and 2006 differed from the amount computed by applying the U.S. Federal income tax rate of 34% to earnings before Federal income taxes as a result of the following:

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	<u>2004</u>	<u>2005</u>	<u>2006</u>
Expected income tax	\$ 6,273,995	\$ 5,456,373	\$ 7,767,807
Foreign earned income not subject to direct taxation	(3,132,853)	(3,488,277)	(5,793,898)
(Reversal)Establishment of Valuation allowance	(494,399)	(554,515)	1,141,979
Tax exempt interest	(275,681)	(385,621)	(639,064)
State taxes and other	<u>1,324,888</u>	<u>363,787</u>	<u>(162,532)</u>
Total income tax	\$ 3,695,950 =====	\$1,391,747 =====	\$2,314,292 =====

In 2004, given the historical loss position of American Safety RRG, it had established a 100% valuation allowance on its net deferred tax assets totaling \$54,515. In 2005, American Safety RRG reduced income tax expense by reversing this valuation allowance as the realizability of the deferred tax assets changed due to American Safety RRG's profitability. This reduction in income tax expense was offset by an increase in minority interest expense and had no overall effect on the earnings or shareholders' equity of the Company. However in 2006, American Safety RRG's profitability changed and the Company believes it will not realize the full benefit of the deferred tax assets, therefore a 100% valuation allowance of \$1,141,979 was established at December 31, 2006. For 2005 and 2006, the reversal and establishment of the valuation allowance has been included in income tax expense with a corresponding offset in minority interest.

Deferred income taxes are based upon temporary differences between the financial statement and tax bases of assets and liabilities. The following deferred taxes are recorded:

	<u>December 31,</u>	
	<u>2005</u>	<u>2006</u>
Deferred tax assets:		
Loss reserve discounting	\$ 9,288,244	\$ 8,095,876
Unearned premium reserves	3,118,965	2,365,798
Warranty reserve	154,980	152,475
Unrealized loss on securities	500,823	434,144
NOL Carryforward	-	817,709
Other	<u>348,009</u>	<u>332,602</u>
Gross deferred tax assets	13,411,021	12,198,604
Valuation allowance	<u>-</u>	<u>(1,141,979)</u>
Gross deferred tax assets after valuation allowance	13,411,021	11,056,625
Deferred tax liabilities:		
Deferred acquisition costs	1,477,230	809,507
Unrealized gain on securities	<u>-</u>	<u>131,249</u>
Gross deferred tax liabilities	<u>1,477,230</u>	<u>940,756</u>
Net deferred tax assets	\$11,933,791 =====	\$10,115,869 =====

(7) Insurance Accounting

The consolidated financial statements have been prepared in conformity with GAAP which vary in certain respects, for the Company, American Safety Casualty, American Safety Indemnity and American Safety RRG, from statutory accounting practices prescribed or permitted by regulatory authorities. Statutory accounting practices include state laws, regulations, and general administrative rules, as well as a variety of publications of the National Association of Insurance Commissioners (the NAIC). The NAIC membership adopted the Codification of Statutory Accounting Principles Project (the Codification) as the NAIC-supported basis of accounting. The Codification was approved with a provision allowing for commissioner discretion in determining appropriate statutory accounting for insurers. Accordingly, such discretion will continue to allow prescribed or permitted accounting practices that may differ from state to state.

The maximum amount of dividends the Company's insurance subsidiaries can pay out without prior written approval from the subsidiaries' domicile state insurance commissioners, is limited to the greater of 10% of surplus as regards to policyholders or net income, excluding realized capital gains of the preceding year. Dividends are also limited to the amount of unassigned surplus.

The NAIC has established risk-based capital (RBC) requirements to help state regulators monitor the financial strength and stability of property and casualty insurers by identifying those companies that may be inadequately capitalized. Under the NAIC's requirements, each insurer must maintain its total capital above a calculated threshold or take corrective measures to achieve the threshold. The threshold of adequate capital is based on a formula that takes into account the amount of risk each company faces on its products and investments. The RBC formula takes into consideration four major areas of risk: (i) asset risk which primarily focuses on the quality of investments; (ii) insurance risk which encompasses coverage-related issues and anticipated frequency and severity of losses when pricing and designing insurance coverages; (iii) interest rate risk which involves asset/liability matching issues; and (iv) other business risks.

American Safety Casualty, American Safety Indemnity and American Safety RRG have calculated their RBC level and have determined that their capital and surplus is in excess of threshold requirements.

The Bermuda Insurance Act of 1978 and related regulations (the Act) requires American Safety Re to meet a minimum solvency margin. American Safety Re's statutory capital and surplus as of December 31, 2004, 2005 and 2006 was \$30,292,863, \$38,586,734 and \$76,447,031, respectively, and the amounts required to be maintained by the Company were \$9,576,055, 12,868,524 and \$21,633,238, respectively. American Safety Assurance, Ltd (ASA) capital and surplus as of December 31, 2005 and 2006 was \$623,425 and \$659,750 respectively. ASA is required to maintain a minimum of \$120,000 in capital. In addition, a minimum liquidity ratio must be maintained whereby relevant assets, as defined by the Act, must exceed 75% of relevant liabilities. Once these requirements have been met, there is no restriction on the remaining retained earnings available for distribution.

(8) Loans Payable

*Trust Preferred Offerings*

In 2003 American Safety Capital and American Safety Capital II, both non-consolidated, wholly-owned subsidiaries of the Company, issued \$8 million and \$5 million, respectively, of variable rate 30-year trust preferred securities. The proceeds are being used by the Company to support the growth of its insurance business. The securities require interest payments on a quarterly basis calculated at a floating rate of LIBOR + 4.2% and LIBOR + 3.95% for American Safety Capital and American Safety Capital II, respectively. The securities can be redeemed at the Company's option commencing five years from the date of original issuance.

In 2005, the American Safety Capital Trust III, a non-consolidated wholly-owned subsidiary of the Company, issued a 30-year trust preferred obligation in the amount of \$25 million. This obligation bears a fixed interest rate of 8.31% for the first five years and LIBOR plus 3.4% thereafter. Interest is payable on a quarterly basis and the securities may be redeemed at the Company's option commencing five years from the date of original issuance.



The underlying debt obligations between the Company and American Safety Capital and American Safety Capital II expose the Company to variability in interest payments due to changes in interest rates. Management entered into an interest rate swap for these trust preferred offerings to manage that variability. Under each interest rate swap, the Company receives variable interest payments and makes fixed interest rate payments to the applicable capital trust entity, thereby creating fixed rate long-term debt. The overall effective fixed rate expense as a result of this hedge is 7.1% and 7.6% for American Safety Capital and American Safety Capital II, respectively, over the first five years of the obligation.

Interest expense for the twelve months ended December 31, 2005 and December 31, 2006 includes no gains or losses from the interest rate swaps. Changes in fair value of the interest rate swaps designated as hedging instruments of the variability of cash flow associated with a floating rate, long-term debt obligation are reported in accumulated other comprehensive income. The gross unrealized gains on the interest rate swaps at December 31, 2005 and December 31, 2006 were \$347,481 and \$263,973 for American Safety Capital and \$141,742 and \$122,052 for American Safety Capital II, respectively. The interest rate swaps are 100% effective at December 31, 2006.

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(9) Related Party and Affiliate Transactions

ASI Services, American Safety's underwriting and administrative services subsidiary leased office from an entity which was owned by certain directors, officers and shareholders of the Company. The lease commenced on March 1, 2001 with an original term through August 31, 2007. This lease was terminated in 2006. The Company paid rent associated with the former space of \$519,814 and \$533,093 in 2006 and 2005, respectively. See Part I, Item 2, Properties for more information about the Company's offices.

(10) Segment Information

During 2006, we changed our segment reporting to coincide with our strategic direction. In our segment reporting for periods prior to the year ended December 31, 2006 we segregated our business into real estate operations, insurance operations and other (which included realized gains and losses on investments and rescission expenses). We continue to segregate our business into real estate operations, insurance operations and other, but the insurance operations segment is further classified into three additional segments: excess and surplus lines, alternative risk transfer and runoff. The excess and surplus lines segment is further classified into five business lines: environmental, construction, non construction, excess and surety. The alternative risk transfer segment is further classified into two business lines: specialty programs and fully-funded. Prior year amounts have been reclassified to conform to the current year presentation. Our real estate operations consist solely of our development of the Harbour Village property as described below under Business Harbour Village Development.

In our E&S line, Environmental Specialty writes insurance coverages for the environmental remediation industry. Construction provides commercial casualty insurance coverages, generally in the area of residential and commercial. Non-construction and excess provides general and products liability business for primary and excess products. Surety provides payment and performance bonds to the environmental remediation industry.

In our ART line, Specialty Programs facilitates the offering of insurance to homogeneous niche groups of risks. Fully funded provides a mechanism for insureds to post collateral and self-insure all or a portion of their risks. We are paid a fee for arranging this type of transaction.

The Other segment consists of amounts associated with realized gains and losses on investments and also for rescission expenses.

The Company measures all segments using net income, total assets and total equity. The Reportable Insurance Operations segments are measured by net premiums earned, incurred losses and loss adjustment expenses and acquisition expenses. Assets are not allocated to the Reportable Insurance Operations segments. The following table presents key financial data by segment for years ended December 31, 2004, December 31, 2005 and December 31, 2006 (in thousands):

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December 31, 2004	Real Estate	Insurance					
		E&S			Excess	Surety	ART Specialty Programs
		Env.	Const.	Non-Const.			
Gross premiums written	-	44,157	94,747	-	2,158	1,725	76,264
Net premiums written	-	35,024	77,462	-	432	1,174	17,273
Fee income written	-	-	-	-	-	-	-
Net premiums earned	-	32,152	79,559	-	222	1,138	16,516
Fee income earned	-	-	-	-	-	-	-
Losses & loss adjustment expenses	-	15,094	55,998	-	133	477	10,929
Acquisition expenses	-	7,729	17,716	-	51	249	324
Underwriting profit (loss)	-	9,329	5,845	-	38	412	5,263
Income tax expense (benefit)	4,670				1,368)		
Net earnings (loss)	7,816				4,263		
Assets	8,729				574,192		
Equity	5,547				103,319		

December 31, 2005	Real Estate	Insurance					
		E&S			Excess	Surety	AR Specialty Programs
		Env.	Const.	Non-Const.			
Gross premiums written	-	51,014	93,315	-	2,091	2,581	85,138
Net premiums written	-	41,477	77,639	-	387	1,345	19,712
Fee income written	-	-	-	-	-	-	-
Net premiums earned	-	38,081	81,451	-	457	1,148	18,297
Fee income earned	-	-	-	-	-	-	-
Losses & loss adjustment expenses	-	19,253	51,651	-	274	1,411	10,298

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Acquisition expenses	-	9,848	17,888	-	(143)	342	1,112
Underwriting profit	-	8,980	11,912	-	326	(605)	6,887
Income tax expense (benefit)	351						
Net earnings (loss)	209				13,618		
Assets	3,031				691,968		
Equity	756				117,679		

December 31, 2006	Real Estate			Insurance			
		Env.	Const.	E&S Non-Const.	Excess	Surety	AR Specialty Programs
Gross premiums written	-	51,805	96,918	2,344	3,946	4,004	80,590
Net premiums written	-	37,746	92,530	1,524	670	3,042	21,756
Fee income written	-	-	-	-	-	-	-
Net premiums earned	-	35,138	88,612	653	532	2,566	19,255
Fee income earned	-	-	-	-	-	-	-
Losses & loss adjustment expenses	-	20,221	58,824	456	319	674	12,135
Acquisition expenses	-	10,390	16,555	122	(130)	569	(128)
Underwriting profit	-	4,527	13,233	75	343	1,323	7,248
Income tax expense (benefit)	124				1,922		
Net earnings (loss)	(506)				20,117		
Assets	918				846,213		
Equity	250				196,001		

Additionally, the Company conducts business in the following geographic segments: country-region United States and Bermuda. Significant differences exist in the regulatory environment in each country. Those differences include laws regarding the measurable information about the insurance geographic segments for the years ended December 31, 2004, December 31, 2005 and December 31, 2006 (in thousands):

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December 31, 2004	United States	Bermuda
Income tax	3,696	-
Net earnings	5,543	9,214
Assets	448,366	134,838
Equity	56,126	52,654
December 31, 2005	United States	Bermuda
Income tax	1,392	-
Net earnings	4,396	10,260
Assets	527,632	167,367
Equity	59,002	59,433
December 31, 2006	United States	Bermuda
Income tax	2,314	-
Net earnings	3,491	17,041
Assets	509,552	337,579
Equity	66,896	129,254

(11) Commitments and Contingencies

At December 31, 2005 and 2006, the Company had aggregate outstanding irrevocable letters of credit which had not been drawn amounting to \$2,000,000 in favor of the Vermont Department of Banking, Insurance, Securities and Health Care Administration. Investments in the amount of \$2,000,000 have been pledged as collateral to the issuing bank.

The Company entered into a lease for approximately 47,000 rentable square feet for its headquarters. The term of the lease is eighty-six months, commencing on February 1, 2007 and extending through March 31, 2014.

The yearly minimum base rent for all operating leases is payable according to the following schedule:

2007	\$ 877,505
2008	\$1,108,316
2009	\$ 979,815
2010	\$ 988,065
2011	\$ 248,983
Thereafter	\$ 3,185,548

(12) Liability for Unpaid Loss and Loss Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows:

<u>2004</u>	<u>Years Ended Dec</u>
	<u>2005</u>
	(In thousand)

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Unpaid loss and loss adjustment expenses, January 1	\$ 230,104	\$ 321,038
Reinsurance recoverable on unpaid losses and loss adjustment expenses January 1	<u>115,061</u>	<u>136,998</u>
Net unpaid loss and loss adjustment expenses, January 1	<u>115,043</u>	<u>184,040</u>
Incurred related to:		
Current year	79,101	81,800
Prior years	<u>14,402</u>	<u>2,606</u>
Total incurred	<u>93,503</u>	<u>84,406</u>
Paid related to:		
Current year	2,567	2,501
Prior years	<u>21,939</u>	<u>31,967</u>
Total paid	<u>24,506</u>	<u>34,468</u>
Net unpaid loss and loss adjustment expenses, December 31	184,040	233,978
Reinsurance recoverable on unpaid loss and loss adjustment expenses, December 31	<u>136,998</u>	<u>159,515</u>
Unpaid loss and loss adjustment expenses, December 31	<u>\$ 321,038</u>	<u>\$ 393,49</u>

The net prior year reserve development for 2004, 2005 and 2006 occurred in the following business lines:

	<u>Year Ended December 31,</u>		
	<u>2004</u>	<u>2005</u>	<u>2006</u>
	(In thousands)		
Excess and Surplus Lines	\$ 94	\$ (754)	\$ 56
Environmental	7,700	2,204	2,425
Construction	<u>37</u>	<u>311</u>	<u>(224)</u>
Surety	7,831	1,761	2,257
Alternative Risk Transfer Programs	1,496	(266)	641
Runoff	<u>5,075</u>	<u>1,111</u>	<u>(300)</u>
Total	<u>\$ 14,402</u>	<u>\$ 2,606</u>	<u>\$ 2,598</u>

The 2006 prior year development in the construction line primarily relates to development in layers where the reinsurance provided by one of the participants in these layers was commuted in 2005. The development in the programs primarily relates to an increase in certain case reserves on policies written in 2004 and 2005. This development is partially offset by reductions in our surety and run-off lines.

In 2005, the Company commuted two excess of loss reinsurance treaties with a former reinsurer. The negotiated commutation price was approximately \$1 million less than the recoverable from the reinsurer which was recorded in the second quarter of 2005. Additionally, in the fourth quarter 2005, the accident year 2001 losses from commercial and residential contractors' claims other than construction defect risk category developed adversely. The Company engaged an actuarial consulting firm in the fourth quarter of 2005 to provide construction defect claim count development patterns

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based on a group of companies writing construction contractors business since the early 1990s in California and other states. We implemented these claim count development patterns, which were based on a larger number of claims and a longer development history than we previously had used in estimating future construction defect claim counts.

Management continually attempts to improve its loss estimation process by refining its ability to analyze loss development patterns, claims payments and other information, but many reasons remain for potential adverse development of estimated ultimate liabilities. For example, the uncertainties inherent in the loss estimation process have become increasingly subject to changes in legal trends. In recent years, this trend has expanded the liability of insureds, established new liabilities and reinterpreted contracts to provide unanticipated coverage long after the related policies were written. Such changes from past experience significantly affect the ability of insurers to estimate the liabilities for unpaid losses and related expenses.

Management recognizes the higher variability associated with certain exposures and books of business and considers this factor when establishing liabilities for losses. Management currently believes the Company's gross and net liabilities are adequate.

The net liabilities for losses and loss adjustment expenses maintained by the Company's insurance subsidiaries are equal under both statutory accounting practices and GAAP.

### (13) Stock Options

The Company's stock option plan grants incentive stock options to employees. The options generally have a term of 10 years. The exercise price is equal to the fair market value at the date of grant. The majority of our options generally vest over three years. At December 31, 2006, 430,627 shares were available for future grants.

The Company applied the recognition and measurement principles of SFAS No. 123R, Share Based Payments, commencing in the first quarter of 2006. Compensation expense relating to stock options of \$614,886 is reflected in earnings for the twelve months ended December 31, 2006. The weighted average fair value of the options was \$7.00 at December 31, 2006.

The following table illustrates the effect on earnings and earnings per share, assuming we had applied the fair value recognition provisions of SFAS No. 123R, Accounting for Share Based Payments, for the twelve months ended December 31, 2004 and 2005.

	Year Ending December 31,	
	<u>2004</u>	<u>2005</u>
	(In thousands, except per share amounts)	
Net earnings		
As reported	\$ 14,757	\$ 14,656
Effect of stock options	<u>(199)</u>	<u>(454)</u>
Pro forma net earnings	\$14,558	\$14,202
	=====	=====
Net earnings per share:		
Basic - as reported	\$2.15	\$2.18
Basic - pro forma	\$2.12	\$2.11
Diluted - as reported	\$2.01	\$2.05
Diluted - pro forma	\$1.98	\$1.99

The following table shows the stock option activity for the Company during 2004, 2005 and 2006.

<u>Option Shares</u>	<u>Weighted average exercise price</u>
----------------------	--

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Outstanding at December 31, 2003	1,010,050	\$ 7.57
2004 activity:		
Granted	136,500	13.68
Exercised	(77,005)	-
Canceled	<u>(20,764)</u>	<u>-</u>
Outstanding at December 31, 2004	1,048,781 =====	\$ 8.25 =====
2005 activity:		
Granted	31,000	16.26
Exercised	(165,768)	-
Canceled	<u>(32,580)</u>	<u>-</u>
Outstanding at December 31, 2005	881,433 =====	\$ 8.62 =====
2006 activity:		
Granted	80,000	17.04
Exercised	(103,668)	-
Canceled	<u>(10,000)</u>	<u>-</u>
Outstanding at December 31, 2006	847,765 =====	\$ 9.33 =====

Of the 1,048,781 outstanding options at December 31, 2004, 633,615 were exercisable.  
Of the 881,433 outstanding options at December 31, 2005, 599,183 were exercisable.  
Of the 847,765 outstanding options at December 31, 2006, 570,766 were exercisable.

The following table summarizes information about stock options outstanding at December 31, 2006:

Range of exercise price	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Grant Year	Nu exerc
\$ 11.00	45,000	1.13	\$11.00	1998	4
9.50	58,450	2.13	9.50	1999	5
6.00	43,200	4.11	6.00	2000	4
6.00	244,000	4.04	6.00	2001	24
8.85	53,416	5.17	8.85	2002	5
6.75	47,116	8.04	6.75	2003	4
8.57	170,000	8.46	8.57	2003	
13.62	500	7.42	13.62	2004	
13.77	10,000	7.58	13.77	2004	
13.67	70,583	7.08	13.67	2004	7
15.99	1,000	8.08	15.99	2005	
16.72	5,000	8.75	16.72	2005	
16.18	25,000	8.90	16.18	2005	
16.40	44,500	9.13	16.40	2006	
16.00	4,000	9.13	16.00	2006	
17.80	10,000	9.70	17.80	2006	
18.50	6,000	9.75	18.50	2006	
19.05	10,000	9.80	19.05	2006	

\$6.00-19.05

847,765

5.88

\$ 9.33

57

For the pro-forma information presented in Note 1(m), the fair value of each option granted during 2004, 2005 and 2006 was estimated on the date of grant using the Black-Scholes multiple option approach with the following assumptions: dividend yield of 0.0% in 2004, 2005 and 2006, respectively; expected volatility of 41.33%, 39.29% and 37.97% in 2004, 2005 and 2006, respectively; risk-free interest rate of 3.5% for 2004 through 2006 and expected life from the grant dates ranging from 0.50 years to 10.00 years. The weighted average fair value of the options during 2004, 2005 and 2006 were \$7.86, \$9.32 and \$9.43 respectively.

The Company expects to grant additional awards in future years. The Company granted options in 2004, 2005 and 2006 at an amount deemed to be fair market value at the date of grant. See Note 1(m) for more information.

#### (14) Litigation

We, through our subsidiaries, are routinely party to pending or threatened litigation or arbitration disputes in the normal course of or related to our business. Based upon information presently available, in view of legal and other defenses available to our subsidiaries, management does not believe that any pending or threatened litigation or arbitration disputes will have any material adverse effect on our financial condition or operating results, except for the matters discussed below.

*Warranty Reinsurance Litigation.* We were named as a defendant in several cases, liquidation actions and reinsurance claims, collectively identified as the National Warranty issue. American Safety Reinsurance, Ltd. ( American Safety Re ) was an excess-of-loss reinsurer through a reinsurance treaty with National Warranty Risk Retention Group ( National Warranty ) that provided insurance coverage to automobile dealerships and other providers that were obligors on automobile warranty contracts they sold to consumers. National Warranty filed for liquidation in the Cayman Islands (the location of its legal creation). This liquidation had a cascading effect, including the subsequent filing of bankruptcy by various obligors of vehicle service contracts insured by National Warranty. As a result, there are potentially over one million vehicle service contracts that are not being honored by the obligors.

The liquidators of National Warranty made claims of \$25.4 million pursuant to two reinsurance contracts issued by American Safety Re to National Warranty in 2002 and 2003. In addition, consumers of vehicle service contracts sued American Safety Re, and the trial court certified that case as a class action, although we appealed that determination. Lastly, claims have been made by sellers/obligors of the vehicle service contracts who were insured by National Warranty. There were five sellers/obligors cases against us and other professional services providers, including other reinsurers, relating to National Warranty, with claims in excess of \$2.6 million. All of these claims were based on fraud and/or theories of contractual violations. We believe that American Safety Re had valid defenses to the claims including, among others, that it had commuted its obligations under reinsurance treaties, its liability is limited to the amount of coverage provided under the policies, which varies based on premium written by National Warranty and its loss ratios, and that most of the claimants cannot make claims directly under the reinsurance contracts.

On November 17, 2006, we entered into a settlement agreement pursuant to which all claims, other than claims by City Automotive and Oak Services as described below, against ASI parties were settled for \$1.8 million, within the amount previously accrued, in exchange for a complete discharge and release. The settlement with the Joint Official Liquidators for National Warranty requires the approval of the Grand Cayman court. The approval is pending but has not yet been obtained.

*City Automotive and Oak Services.* The plaintiffs in these two cases are dealers and marketers of the vehicle service contracts. We have entered into an arbitration agreement with the plaintiffs in exchange for a dismissal of all ASI parties from the pending litigation. Pursuant to this arbitration agreement, there is a floor and a ceiling to the award the arbitrators can award. The ceiling is reduced by a percentage amount equal the percentage that any recovery by City Automotive and Oak Services in their pending litigation against the remaining defendants or in the National Warranty liquidation bears to the plaintiffs' total damages. The ultimate outcome of these matters cannot now be determined.

*Griggs et al. v. American Safety Reinsurance, Ltd. et al., Case No. 2003-31509,* Circuit Court, Seventh Judicial District, Volusia County, State Florida. Seven plaintiffs filed suit against us and three of our subsidiaries seeking to recover a \$2.1 million loan made by the plaintiffs in 1986 to Ponce Marina, Inc., the former owner of the Harbour Village property. The plaintiffs claimed that we were responsible for the repayment of the loan, with interest. The plaintiffs propounded four theories of liability and the court granted judgment for us on three of the theories. However, the court entered judgment on August 10, 2005 against us for approximately \$3.4 million, which includes interest, on the remaining theory. The court held that we, as a condition of our loan, required Ponce Marina, Inc. to demand that the plaintiffs enter into an agreement with Ponce Marina, Inc., to the detriment of their loans and to our benefit, and thus, we had entered into a quasi-contract with the



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plaintiffs to repay their loan with interest.

We filed an appeal in December 2005, and oral argument on our appeal was heard on December 5, 2006. The Court has not yet issued a decision on our appeal. Based on the merits of the case and likelihood of ultimate payment, we have not established an accrual for the decision. The ultimate outcome of this matter cannot now be determined.

*Sizemore v. American Safety Insurance Services, Inc. et al., Case No 2005-31704*, Circuit Court, Seventh Judicial District, Volusia County, Florida. American Safety Insurance Services, Inc., its parents and a number of its affiliates are defendants in a suit brought by an individual who contends that defendants are liable to him for a debt owed to him by Ponce Marina, Inc. in the amount of \$400,000 plus interest and costs. The plaintiff also intends to seek class certification on behalf of himself and 21 other unnamed plaintiffs for the case on these claims in excess of \$1.7 million plus interest and costs. On January 27, 2006, the trial court dismissed the case. The plaintiff was permitted to file an amended complaint on or before March 6, 2006. The plaintiff filed an amended complaint on March 7, 2006, alleging various theories of recovery, some of which were also alleged in the *Griggs* case. On May 4, 2006, the trial court dismissed the case and gave the plaintiff 20 days to file an amended complaint. The plaintiff filed a third amended complaint and our third Motion to Dismiss was heard on August 22, 2006, and on September 18, 2006, the plaintiff's case was dismissed with prejudice. On October 17, 2006, the plaintiff filed an appeal of the dismissal. We continue to vigorously defend this case, as we believe that the case is without merit. Based on the merits of the case and the likelihood of ultimate payment, we have not established an accrual. The ultimate outcome of this matter cannot now be determined.

### AMERICAN SAFETY INSURANCE HOLDINGS, LTD.

#### SELECTED QUARTERLY FINANCIAL DATA

(UNAUDITED)

The following table presents the quarterly results of consolidated operations for 2005 (dollars in thousands, except per share amounts):

2005	<u>Mar. 31</u>	<u>June 30</u>	<u>Sept. 30</u>
Total revenues	\$ 40,207	\$ 38,623	\$ 35,029
Income before taxes	3,897	3,431	4,430
Net earnings	3,646	3,139	3,347
Comprehensive income	147	7,002	344
Net earnings per share:			
Basic	\$ 0.54	\$ 0.47	\$ 0.50
Diluted	0.50	0.44	0.47
Common stock price ranges:			
High	\$ 16.45	\$ 15.75	\$ 17.98
Low	14.02	14.17	15.17
2006	<u>Mar. 31</u>	<u>June 30</u>	<u>Sept. 30</u>
Total revenues	\$ 40,105	\$ 40,376	\$ 45,021
Income before taxes	4,117	5,227	5,731
Net earnings	4,100	4,627	5,388
Comprehensive income	944	1,455	14,036
Net earnings per share:			
Basic	\$ 0.61	\$ 0.65	\$ 0.52
Diluted	0.57	0.62	0.50
Common stock price ranges:			
High	\$ 16.97	\$ 17.58	\$ 18.40

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**AMERICAN SAFETY INSURANCE HOLDINGS, LTD. (PARENT ONLY)**
**SCHEDULE II CONDENSED BALANCE SHEETS****DECEMBER 31, 2005 AND 2006**

	<u>2005</u>	<u>2006</u>
Assets		
Investment in subsidiaries	\$ 104,160,885	\$ 155,219,686
Other investments:		
Fixed maturities	4,753,607	27,596,656
Common stock	9,125,625	10,252,812
Short term investments	110,231	729,437
Secured note receivable from affiliate	<u>2,500,000</u>	<u>2,500,000</u>
Total other investments	16,489,463	196,298,591
Cash and cash equivalents	1,518	73,340
Accrued investment income	48,615	280,402
Other assets	<u>21,570</u>	<u>273,175</u>
Total assets	\$120,722,051	\$196,925,508
Liability and shareholders' equity		
Due to related party	\$ 2,107,973	-
Accounts payable and accrued expenses	<u>78,831</u>	<u>675,328</u>
Total liabilities	<u>2,186,804</u>	<u>675,328</u>
Preferred stock	<u>100,000</u>	<u>100,000</u>
Common stock	67,537	105,542
Additional paid in capital	49,460,019	104,514,210
Accumulated other comprehensive earnings (losses), net	(1,549,661)	540,888
Retained earnings	<u>70,457,352</u>	<u>90,989,540</u>
Total shareholders' equity	<u>118,435,247</u>	<u>196,150,180</u>
Total liabilities and shareholders' equity	\$120,722,051	\$196,925,508
	=====	=====
See accompanying independent auditors' report.		

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**AMERICAN SAFETY INSURANCE HOLDINGS, LTD. (PARENT ONLY)**
**SCHEDULE II CONDENSED STATEMENTS OF OPERATIONS****YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006**

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Revenues:			
Investment income	\$515,024	\$314,437	\$1,754,
Realized gains (losses) on sales of investments	<u>7,283</u>	<u>(20,140)</u>	<u>91,</u>
Total Revenues	<u>522,304</u>	<u>294,297</u>	<u>1,845,</u>
Expenses:			
Other underwriting expenses	<u>1,792,178</u>	<u>1,398,267</u>	<u>1,942,</u>
Total Expenses	<u>1,792,178</u>	<u>1,398,267</u>	<u>1,942,</u>

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Net loss before equity in net earnings of subsidiary	(1,269,874)	(1,103,970)	(96,
Equity in net earnings of subsidiary	<u>16,026,849</u>	<u>15,760,380</u>	<u>20,629,</u>
Net earnings	<u>\$14,756,975</u>	<u>\$ 14,656,410</u>	<u>\$ 20,532,</u>
	=====	=====	=====

See accompanying independent auditors' report.

**AMERICAN SAFETY INSURANCE HOLDINGS, LTD. (PARENT ONLY)**  
**SCHEDULE II - STATEMENTS OF CASH FLOW**  
**YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006**

	<u>2004</u>	<u>2005</u>
Cash flow from operating activities:		
Net loss before equity in earnings of subsidiary	\$ (1,269,874)	\$ (1,103,970)
Adjustments to reconcile net earnings (loss) to net cash provided by (used in) operating activities:		
Change in operating assets and liabilities:		
Accrued investment income	104,179	35,522
Premiums receivable/payable	-	-
Due from/to affiliate	(752,043)	(214,583)
Unpaid losses and loss adjustment expenses	-	-
Accounts payable and accrued expenses	(176,678)	70,375
Assumed loss and LAE payable	-	-
Other, net	<u>797,694</u>	<u>135,766</u>
Net cash used in operating activities	(1,296,722)	(1,076,890)
Cash flow from investing activities:		
Decrease (increase) in investments	7,428,345	2,456,282
Investment in subsidiary	(4,307,242)	-
Decrease (increase) in short term investments	<u>52,796</u>	<u>282,345</u>
Net cash provided by (used in) investing activities	3,173,899	2,738,627
Cash flow from financing activities:		
Proceeds from sale of common stock	638,495	1,218,455
Stock repurchase payments	<u>(2,485,209)</u>	<u>(2,945,714)</u>
Net cash provided by (used in) financing activities	<u>(1,846,714)</u>	<u>(1,727,259)</u>
Net (decrease) increase in cash	30,463	(65,522)
Cash and cash equivalents, beginning of year	<u>36,577</u>	<u>67,040</u>
Cash and cash equivalents, end of year	\$ 67,040	\$ 1,518
	=====	=====

See accompanying independent auditors' report.

**AMERICAN SAFETY INSURANCE HOLDINGS, LTD. (PARENT ONLY)**  
**SCHEDULE II -CONDENSED STATEMENTS OF COMPREHENSIVE INCOME**  
**YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006**

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	<u>2004</u>	<u>2005</u>
Net earnings	\$ 14,756,975	\$ 14,656,410
Other comprehensive income (loss):		
Unrealized gains (losses) on securities available-for sale, net of minority interest of \$(108,334) \$11,815 and \$(259,129) for 2004, 2005 and 2006, respectively.	463,260	(4,541,890)
Unrealized gains (losses) on hedging transactions	81,912	311,359
Reclassification adjustment for realized (gains) losses included in net earnings, net of minority interest of \$(86,986), \$0 and \$25,530 for 2004, 2005 and 2006, respectively.	<u>(121,149)</u>	<u>54,101</u>
Total other comprehensive income (loss) before income taxes.	424,023	(4,176,430)
Income tax expense (benefit) related to items of other comprehensive income, net of minority interest of \$0 for 2004, \$(5,534) for 2005 and \$9,071 for 2006 respectively.	<u>65,933</u>	<u>(783,351)</u>
Other comprehensive income (loss)	<u>358,090</u>	<u>(3,393,079)</u>
Total comprehensive income	\$ 15,115,065 =====	\$ 11,263,331 =====

See accompanying independent auditors' report.

**AMERICAN SAFETY INSURANCE HOLDINGS, LTD.  
SCHEDULE III - SUPPLEMENTAL INFORMATION CONCERNING  
PROPERTY-CASUALTY INSURANCE OPERATIONS  
(dollars in thousands)**

	Column B	Column C	Column D	Column E	Column F	Column G	Column H
	Deferred Policy Acquisition Costs	Reserves for Unpaid Claims and Claim Adjustment Expenses	Discount, if any, Deducted in Column C	Net Unearned Premiums	Net Earned Premiums	Net Investment Income (1)	Claims and Adjustment Expense Incurred Re to  Current Year
<b>2004</b>							
E&S							
Environmental	\$4,107	\$32,889	-	\$19,384	\$32,152	-	\$15,000
Runoff							36

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Construction	7,400	107,282	-	41,895	79,559	-	48,298	7
Excess	(63)	132	-	208	222	-	133	
Surety	<u>38</u>	<u>270</u>	-	<u>195</u>	<u>1,138</u>	-	<u>440</u>	
	11,482	140,573		60,972	113,071		63,871	7
ART Programs	256	18,810	-	6,993	16,516	-	9,433	1
Runoff	<u>-</u>	<u>24,657</u>	-	<u>211</u>	<u>6,714</u>	<u>-</u>	<u>5,797</u>	5
Total	\$11,738	\$184,040		\$68,176	\$136,301	\$9,773	\$79,101	\$14
	=====	=====		=====	=====	=====	=====	=====

**2005**

E&S								
Environmental	\$4,569	\$45,205	-	\$27,779	\$38,081	-	\$20,007	\$
Construction	6,372	142,512	-	37,161	81,451	-	49,447	2
Excess	85	407	-	349	457	-	274	
Surety	91	220	-	391	1,148	-	1,100	1
	11,117	188,344		60,680	121,138		70,828	1
ART Programs	(235)	21,412	-	8,432	18,297	-	10,375	
Runoff	<u>-</u>	<u>24,222</u>	-	<u>-</u>	<u>(1,854)</u>	-	<u>408</u>	
Total	\$10,882	\$233,978		\$69,112	\$137,580	\$14,316	\$81,800	\$
	=====	=====		=====	=====	=====	=====	=====

**2006**

E&S								
Environmental	\$5,117	\$51,316	-	\$22,579	\$35,235	-	\$20,165	\$
Construction	7,544	179,282	-	41,288	88,612	-	\$56,398	
Non-Construction	(15)	424	-	871	653	-	456	
Excess	(181)	726	-	278	532	-	319	
Surety	<u>213</u>	<u>174</u>	-	<u>867</u>	<u>2,566</u>	-	<u>898</u>	
	12,678	231,922		65,883	127,598		\$78,236	\$
ART Programs	(275)	27,269	-	13,417	19,255	-	11,495	
Runoff	<u>-</u>	<u>19,336</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total	\$12,403	\$278,527		\$79,300	\$146,853	\$1,767	\$89,731	\$
	=====	=====		=====	=====	=====	=====	=====

(1) The Company does not allocate net investment income or other operating expenses to the business segments.

See accompanying independent auditors' report.

**AMERICAN SAFETY INSURANCE HOLDINGS, LTD.**  
**SCHEDULE IV - REINSURANCE**  
**YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006**  
**(Dollars in thousands)**

	Ceded to	Assumed from Other
Runoff		

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Property-Liability Insurance Premiums Earned	Gross Amount	Other Companies	Companies	Net Amount
<b>United States</b>				
December 31, 2004	\$ 223,052	\$ 90,751	\$ 4,000	\$ 136,301
December 31, 2005	\$ 229,238	\$ 91,577	\$ (81)	\$ 137,580
December 31, 2006	\$ 222,257	\$ 75,636	\$ 135	\$ 146,756
<b>Bermuda</b>				
December 31, 2004	-	-	-	-
December 31, 2005	-	-	-	-
December 31, 2006	-	-	-	-
<b>Combined Total</b>				
December 31, 2004	\$ 223,052	\$ 90,751	\$ 4,000	\$ 136,301
December 31, 2005	\$ 229,238	\$ 91,517	\$ (81)	\$ 137,580
December 31, 2006	\$ 222,257	\$ 75,636	\$ 135	\$ 146,756

See accompanying independent auditors' report.