

ARCH CAPITAL GROUP LTD.  
Form 10-Q/A  
August 04, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q/A**  
**Amendment No. 1**

(Mark One)

☒

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2006

Or

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**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-26456

**ARCH CAPITAL GROUP LTD.**

(Exact name of registrant as specified in its charter)

**Bermuda**

(State or other jurisdiction of incorporation or  
organization)

**Not Applicable**

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

**Wessex House, 45 Reid Street  
Hamilton HM 12, Bermuda**

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: **(441) 278-9250**

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(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

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 Exchange Act).

Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common shares as of the latest practicable date.

Class	Outstanding at May 1, 2006
Common Shares, \$0.01 par value	73,880,077

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**QUARTERLY REPORT ON FORM 10-Q/A**  
**For the quarterly period ended March 31, 2006**

**EXPLANATORY NOTE**

This Form 10-Q/A (the "10-Q/A") is being filed by Arch Capital Group Ltd. ("ACGL") to correct a date in the Report of the Independent Registered Public Accounting Firm related to ACGL's Financial Statements (the "Report") within ACGL's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006 (the "Original 10-Q") filed with the Securities and Exchange Commission (the "SEC") on May 8, 2006. The reference to the date of the report in the fourth paragraph should be March 13, 2006. Except as described above, no change has been made to the Original 10-Q.

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**ARCH CAPITAL GROUP LTD.**

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To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of March 31, 2006, the related consolidated statements of income, changes in shareholders' equity, comprehensive income and cash flows for the three-month periods ended March 31, 2006 and 2005. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2005, and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and cash flows for the year then ended, management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 and the effectiveness of the Company's internal control over financial reporting as of December 31, 2005; and in our report dated March 13, 2006, we expressed unqualified opinions thereon. The consolidated financial statements and management's assessment of the effectiveness of internal control over financial reporting referred to above are not presented herein. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2005, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP  
New York, New York  
May 8, 2006

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(U.S. dollars in thousands, except share data)

	(Unaudited) March 31, 2006	December 31, 2005
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2006, \$5,488,075; 2005, \$5,310,712)	\$ 5,414,156	\$ 5,280,987
Short-term investments available for sale, at fair value (amortized cost: 2006, \$1,052,669; 2005, \$679,530)	1,052,753	681,887
Short-term investment of funds received under securities lending agreements, at fair value	882,950	893,379
Other investments, at fair value (cost: 2006, \$89,100; 2005, \$59,839)	102,351	70,233
Total investments	7,452,210	6,926,486
Cash	247,906	222,477
Accrued investment income	59,936	62,196
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value	858,283	863,866
Premiums receivable	872,975	672,902
Funds held by reinsureds	131,968	167,739
Unpaid losses and loss adjustment expenses recoverable	1,441,412	1,389,768
Paid losses and loss adjustment expenses recoverable	63,803	80,948
Prepaid reinsurance premiums	376,815	322,435
Deferred income tax assets, net	83,595	71,139
Deferred acquisition costs, net	327,491	317,357
Other assets	444,746	391,123
<b>Total Assets</b>	<b>\$ 12,361,140</b>	<b>\$ 11,488,436</b>
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 5,760,939	\$ 5,452,826
Unearned premiums	1,867,250	1,699,691
Reinsurance balances payable	226,892	150,451
Senior notes	300,000	300,000
Deposit accounting liabilities	49,646	43,104
Securities lending collateral	882,950	893,379
Payable for securities purchased	35,690	12,020
Other liabilities	488,219	456,438
<b>Total Liabilities</b>	<b>9,611,586</b>	<b>9,007,909</b>
<b>Commitments and Contingencies</b>		
<b>Shareholders' Equity</b>		
Series A non-cumulative preferred shares (\$0.01 par value, 50,000,000 shares authorized, issued: 2006, 8,000,000)	80	
Common shares (\$0.01 par value, 200,000,000 shares authorized, issued: 2006, 73,827,467; 2005, 73,334,870)	738	733
Additional paid-in capital	1,794,410	1,595,440
Deferred compensation under share award plan		(9,646)
Retained earnings	1,030,971	901,348
Accumulated other comprehensive income (loss), net of deferred income tax	(76,645)	(7,348)
<b>Total Shareholders' Equity</b>	<b>2,749,554</b>	<b>2,480,527</b>



<b>Total Liabilities and Shareholders</b>	<b>Equity</b>	\$	12,361,140	\$	11,488,436
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See Notes to Consolidated Financial Statements

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(U.S. dollars in thousands, except share data)

	(Unaudited) Three Months Ended March 31,	
	2006	2005
<b>Revenues</b>		
Net premiums written	\$ 873,719	\$ 799,801
Increase in unearned premiums	(112,118)	(102,733)
Net premiums earned	761,601	697,068
Net investment income	80,326	49,916
Net realized gains (losses)	(3,383)	461
Fee income	1,805	6,112
<b>Total revenues</b>	<b>840,349</b>	<b>753,557</b>
<b>Expenses</b>		
Losses and loss adjustment expenses	468,178	425,536
Acquisition expenses	129,672	126,133
Other operating expenses	82,977	74,175
Interest expense	5,555	5,636
Net foreign exchange (gains) losses	10,253	(3,237)
<b>Total expenses</b>	<b>696,635</b>	<b>628,243</b>
<b>Income before income taxes</b>	<b>143,714</b>	<b>125,314</b>
Income tax expense	11,424	9,422
<b>Net income</b>	<b>132,290</b>	<b>115,892</b>
Preferred dividends	2,667	
<b>Net income available to common shareholders</b>	<b>\$ 129,623</b>	<b>\$ 115,892</b>
<b>Net income per common share</b>		
Basic	\$ 1.78	\$ 3.37
Diluted	\$ 1.71	\$ 1.57
<b>Weighted average common shares and common share equivalents outstanding</b>		
Basic (1)	72,899,249	34,364,818
Diluted (1)	75,855,309	74,013,546

- (1) For the 2005 period, basic weighted average common shares and common share equivalents outstanding excluded 37,331,402 series A convertible preference shares. Such shares were included in the diluted weighted average common shares and common share equivalents outstanding. During the 2005 fourth quarter, all remaining series A convertible preference shares were converted into an equal number of common shares.

See Notes to Consolidated Financial Statements



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2006	2005
<b>Series A Convertible Preference Shares</b>		
Balance at beginning of year	\$	\$ 373
Converted to common shares		(0)
Balance at end of period		373
<b>Series A Non-Cumulative Preferred Shares</b>		
Balance at beginning of year		
Preferred shares issued	80	
Balance at end of period	80	
<b>Common Shares</b>		
Balance at beginning of year	733	349
Common shares issued, net	5	2
Balance at end of period	738	351
<b>Additional Paid-in Capital</b>		
Balance at beginning of year	1,595,440	1,560,291
Cumulative effect of change in accounting for unearned stock grant compensation	(9,646)	
Series A non-cumulative preferred shares issued	193,378	
Common shares issued	160	1,127
Exercise of stock options	12,152	3,710
Common shares retired	(647)	(838)
Amortization of share-based compensation	3,299	
Other	274	198
Balance at end of period	1,794,410	1,564,488
<b>Deferred Compensation Under Share Award Plan</b>		
Balance at beginning of year	(9,646)	(9,879)
Cumulative effect of change in accounting for unearned stock grant compensation	9,646	
Restricted common shares issued		
Deferred compensation expense recognized		1,985
Balance at end of period		(7,894)
<b>Retained Earnings</b>		
Balance at beginning of year	901,348	644,862
Dividends declared on preferred shares	(2,667)	
Net income	132,290	115,892
Balance at end of period	1,030,971	760,754
<b>Accumulated Other Comprehensive Income (Loss)</b>		
Balance at beginning of year	(7,348)	45,910
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	(67,032)	(74,772)
Foreign currency translation adjustments, net of deferred income tax	(2,265)	(346)
Balance at end of period	(76,645)	(29,208)
<b>Total Shareholders' Equity</b>	<b>\$ 2,749,554</b>	<b>\$ 2,288,864</b>

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2006	2005
<b>Comprehensive Income</b>		
Net income	\$ 132,290	\$ 115,892
Other comprehensive income (loss), net of deferred income tax		
Unrealized decline in value of investments:		
Unrealized holding losses arising during period	(67,987)	(75,341)
Reclassification of net realized losses, net of income taxes, included in net income	955	569
Foreign currency translation adjustments	(2,265)	(346)
<b>Other comprehensive loss</b>	(69,297)	(75,118)
<b>Comprehensive Income</b>	\$ 62,993	\$ 40,774

See Notes to Consolidated Financial Statements

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2006	2005
<b>Operating Activities</b>		
Net income	\$ 132,290	\$ 115,892
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses	783	426
Share-based compensation	3,299	2,095
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	256,469	250,323
Unearned premiums, net of prepaid reinsurance premiums	113,179	103,071
Premiums receivable	(200,073)	(122,096)
Deferred acquisition costs, net	(10,134)	(19,429)
Funds held by reinsureds	35,771	19,927
Reinsurance balances payable	76,441	(20,032)
Paid losses and loss adjustment expenses recoverable	17,145	(2,861)
Deferred income tax assets, net	(7,352)	3,646
Deposit accounting liabilities	6,542	4,180
Other liabilities	22,460	7,155
Other items, net	(23,642)	(14,457)
<b>Net Cash Provided By Operating Activities</b>	<b>423,178</b>	<b>327,840</b>
<b>Investing Activities</b>		
Purchases of fixed maturity investments	(4,330,266)	(938,227)
Proceeds from sales of fixed maturity investments	4,121,591	548,030
Proceeds from redemptions and maturities of fixed maturity investments	83,394	74,943
Purchases of other investments	(32,596)	
Proceeds from sales of other investments	5,359	1,786
Net purchases of short-term investments	(444,527)	(39,102)
Change in securities lending collateral	10,429	
Purchases of furniture, equipment and other	(4,602)	(3,020)
<b>Net Cash Used For Investing Activities</b>	<b>(591,218)</b>	<b>(355,590)</b>
<b>Financing Activities</b>		
Proceeds from common shares issued, net of repurchases	8,690	2,125
Net proceeds from preferred shares issued	193,527	
Change in securities lending collateral	(10,429)	
Excess tax benefits from share-based compensation	2,450	
<b>Net Cash Provided By Financing Activities</b>	<b>194,238</b>	<b>2,125</b>
Effects of exchange rate changes on foreign currency cash	(769)	(704)
Increase (decrease) in cash	25,429	(26,329)
Cash beginning of year	222,477	113,052
<b>Cash end of period</b>	<b>\$ 247,906</b>	<b>\$ 86,723</b>
Income taxes paid, net	\$ 9,591	\$ 15,796
Interest paid	\$ 42	\$ 58
Declaration of preferred dividends to be paid	\$ 2,667	





**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. General**

Arch Capital Group Ltd. ( ACGL ) is a Bermuda public limited liability company which provides insurance and reinsurance on a worldwide basis through its wholly owned subsidiaries.

The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ( GAAP ) and include the accounts of ACGL and its wholly owned subsidiaries (together with ACGL, the Company ). All significant intercompany transactions and balances have been eliminated in consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions. In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all adjustments (consisting of normally recurring accruals) necessary for a fair statement of results on an interim basis. The results of any interim period are not necessarily indicative of the results for a full year or any future periods.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2005, including the Company's audited consolidated financial statements and related notes and the section entitled Risk Factors.

To facilitate period-to-period comparisons, certain amounts in the 2005 consolidated financial statements have been reclassified to conform to the 2006 presentation. Such reclassifications had no effect on the Company's consolidated net income.

**2. Share-Based Compensation**

***Stock Options***

Effective January 1, 2006, the Company adopted the fair value method of accounting for share-based compensation arrangements in accordance with Financial Accounting Standards Board ( FASB ) Statement No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123(R) ), using the modified prospective method of transition. Under the fair value method of accounting, compensation expense is estimated based on the fair value of the award at the grant date and is recognized in net income over the requisite service period. Such compensation cost is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. Under the modified prospective approach, the fair value based method described in SFAS No. 123(R) is applied to new awards granted after January 1, 2006. Additionally, compensation expense for unvested stock options that are outstanding as of January 1, 2006 will be recognized in net income as the requisite service is rendered based on the grant date fair value of those options as previously calculated under pro forma disclosures under SFAS No. 123, Accounting for Stock-Based

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Compensation ( SFAS No. 123 ), as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure. Therefore, under the modified prospective method, compensation expense is recognized beginning with the effective date of adoption of SFAS No.123(R) for all stock option awards (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and that remain unvested on the date of adoption.

Prior to January 1, 2006, the Company accounted for its share-based compensation related to stock option awards using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and its related interpretations permitted by SFAS No. 123, which did not require the recognition of compensation expense related to the issuance of

stock options so long as the quoted market price of the Company's stock at the date of grant was less than or equal to the amount an employee must pay to acquire the stock.

As required by the provisions of SFAS No. 123(R), the Company recorded \$1.1 million of after-tax share-based compensation expense, or \$0.01 per basic and diluted share, related to stock option awards for the 2006 first quarter. Such amount was net of a tax benefit of \$0.2 million. The share-based compensation expense associated with stock options that have graded vesting features and vest based on service conditions only (i) granted after the effective date of adoption is calculated on a straight-line basis over the requisite service periods of the related options and (ii) granted prior to the effective date of adoption and that remain unvested as of the date of adoption is calculated on a graded-vesting basis as prescribed under FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans an interpretation of APB Opinions No. 15 and 25, over the remaining requisite service periods of the related options. These charges had no impact on the Company's cash flows or total shareholders' equity.

Under the modified prospective method of transition under SFAS No.123(R), the Company is not required to restate its prior period financial statements to reflect expensing of share-based compensation under SFAS No. 123(R). Therefore, the results for the 2006 first quarter are not comparable to the 2005 first quarter. As required by SFAS No.123(R), the Company has presented pro forma disclosures of its net income and earnings per share for the 2005 first quarter assuming the estimated fair value of the options granted prior to January 1, 2006 is amortized to expense over the requisite service period, as indicated below:

(U.S. dollars in thousands, except share data)		(Unaudited) Three Months Ended March 31, 2005
Net income, as reported	\$	115,892
Total share-based employee compensation expense under fair value method, net of income taxes		(1,077)
Pro forma net income	\$	114,815
Earnings per share basic:		
As reported	\$	3.37
Pro forma	\$	3.34
Earnings per share diluted:		
As reported	\$	1.57
Pro forma	\$	1.55

For purposes of disclosure in the foregoing table and for purposes of determining estimated fair value under SFAS No. 123(R), the Company has computed the estimated fair values of share-based compensation related to stock options using the Black-Scholes option valuation model and has applied the assumptions set forth in the following table. In September 2005, the Company's board of directors approved a longer vesting period for future awards to vest over a three year period as follows: one third on the anniversary of the grant date and one-third each year thereafter. Prior to September 2005, awards generally vested over a two year period: one third on the grant date and one-third each year thereafter. The Company increased the expected life assumption for stock options granted beginning in September 2005 to six years after considering the increase in the vesting period, the ten year contractual term of the option awards, the historical share option exercise experience, peer data and guidance from the Securities and Exchange Commission as contained in Staff Accounting Bulletin No. 107 permitting the initial application of a simplified method, which is based on the average of the vesting term and the contractual term of the option. Previously, the Company calculated the estimated life based on the expectation that options would be exercised within five years on average after consideration of the vesting and contractual terms, historical share option exercise experience and peer data. The Company based its estimate of expected volatility for options granted in the



2005 first quarter, the Company based its volatility estimate under the same method as the 2006 first quarter, using the period from September 20, 2002 through the last day of the applicable period.

	(Unaudited) Three Months Ended March 31,	
	2006	2005
Dividend yield	0.0%	0.0%
Expected volatility	21.4%	21.1%
Risk free interest rate	4.56%	4.26%
Expected option life	6.0 years	5.0 years

The Black-Scholes option pricing model requires the input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models may not provide a reliable single measure of the fair value of its employee stock options. In addition, management will continue to assess the assumptions and methodologies used to calculate estimated fair value of share-based compensation. Circumstances may change and additional data may become available over time, which result in changes to these assumptions and methodologies, and which could materially impact the Company's fair value determination.

A summary of option activity under the Company's Long term Incentive and Share Award Plans during the 2006 first quarter is presented below:

	(Unaudited) Three Months Ended March 31, 2006	
	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	5,637,108	\$ 26.30
Granted	843,500	\$ 56.25
Exercised	(393,069)	\$ 23.75
Forfeited or expired	(14,499)	\$ 44.95
Outstanding, end of period	6,073,040	\$ 30.58
Exercisable, end of period	4,713,519	\$ 24.47

The weighted average remaining contractual life of the Company's outstanding and exercisable stock options at March 31, 2006 was 6.6 years and 5.7 years, respectively. The aggregate intrinsic value of the Company's outstanding and exercisable stock options at March 31, 2006 was \$165.0 million and \$156.8 million, respectively. The Company received proceeds of approximately \$9.3 million from the exercise of stock options during the 2006 first quarter.

The weighted average grant-date fair value of options during the 2006 first quarter was \$18.13 per option based on the Black-Scholes option pricing model. The aggregate intrinsic value of options exercised during the 2006 first quarter was approximately \$12.1 million and represents the difference between the exercise price of the option and the closing market price of the Company's common shares on the exercise dates. As of March 31, 2006, there was approximately \$18.2 million of unrecognized compensation cost related to nonvested stock options. Such cost is expected to be recognized over a weighted average period of 1.63 years.

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At March 31, 2006, approximately 1,600,000 and 7,000 shares are available for grant under the 2005 and 2002 share award plans, respectively. The Company issues new shares upon exercise of stock options and when granting restricted shares. For a description of the Company's share award plans and the number of shares

authorized for awards of options or other equity instruments, refer to Note 13, Share Capital Long Term Incentive and Share Award Plans, of the notes accompanying the Company's consolidated financial statements for the year ended December 31, 2005, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

### ***Restricted Common Shares and Restricted Units***

As discussed above, effective January 1, 2006, the Company adopted the fair value method of accounting for share-based compensation arrangements in accordance with SFAS No.123(R), which governs the accounting for all share-based compensation. Under the fair value method of accounting pursuant to SFAS No. 123(R), the fair value for restricted shares and units is measured by the grant-date price of the Company's shares. No value is attributed to awards that employees forfeit because they fail to satisfy vesting conditions. As such, the number of shares granted is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. Such expense is amortized over the requisite service period of the related awards. Restricted share and unit awards granted prior to September 2005 generally vest over a two year period: one-third on the grant date and one-third each year thereafter. Restricted share and unit awards granted subsequent to September 2005 generally vest over a three year period: one third on the first anniversary of the grant date and one-third each year thereafter.

Prior to January 1, 2006, the Company accounted for its share-based compensation related to restricted share and unit awards using the intrinsic value method of accounting in accordance with APB No. 25 and its related interpretations. Compensation expense equal to the market value of the restricted share awards at the measurement date was amortized and recorded in net income over the vesting period. The Company's unearned compensation balance of \$9.6 million as of December 31, 2005, which was accounted for under APB No. 25, was reclassified into additional paid-in capital upon adoption of SFAS No.123(R).

The Company recorded \$1.7 million of share-based compensation expense, net of a tax benefit of \$0.3 million, related to restricted share and unit awards for the 2006 first quarter as required by the provisions of SFAS No.123(R), compared to \$1.7 million, net of a tax benefit of \$0.4 million, for the 2005 first quarter. The share-based compensation expense associated with restricted share and unit awards that have graded vesting features and vest based on service conditions only (i) granted after the effective date of adoption is calculated on a straight-line basis over the requisite service periods of the related awards and (ii) granted prior to the effective date of adoption and that remain unvested as of the date of adoption is calculated on a graded-vesting basis over the remaining requisite service periods of the related awards. These charges had no impact on the Company's cash flows or total shareholders' equity.

A summary of restricted share activity under the Company's Long Term Incentive and Share Award Plans during the 2006 first quarter is presented below:

	(Unaudited) Three Months Ended March 31, 2006	
	Nonvested Shares	Weighted Average Grant Date Fair Value
Unvested balance, beginning of year	666,504	\$ 33.14
Granted	106,143	\$ 56.27
Vested	(52,045)	\$ 36.98
Forfeited	(1,476)	\$ 46.64
Unvested balance, end of period	719,126	\$ 36.25





As of March 31, 2006, 95,870 restricted units were outstanding with an aggregate intrinsic value of \$5.5 million. The aggregate intrinsic value of 6,375 restricted units converted during the 2006 first quarter was \$0.3 million. As of March 31, 2006, there were \$13.7 million and \$0.7 million, respectively, of unrecognized compensation costs related to unvested restricted share and unit awards granted under the Company's Long Term Incentive and Share Award Plans. The unrecognized compensation costs related to unvested restricted share and unit awards are expected to be recognized over a weighted-average period of 1.25 years and 1.16 years, respectively. The total weighted average fair value of restricted shares that vested during the 2006 first quarter was \$2.9 million, or \$56.33 per share.

### 3. Share Transactions

On February 1, 2006, ACGL completed a public offering of \$200.0 million principal amount of 8.0% series A non-cumulative preferred shares ( Series A Preferred Shares ) with a liquidation preference of \$25.00 per share and received net proceeds of \$193.5 million. The net proceeds were used to support the underwriting activities of ACGL's insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of the Series A Preferred Shares at a redemption price of \$25.00 per share on or after February 1, 2011. Dividends on the Series A Preferred Shares are non-cumulative. Consequently, in the event dividends are not declared on the Series A Preferred Shares for any dividend period, holders of Series A Preferred Shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of Series A Preferred Shares will be entitled to receive dividend payments only when, as and if declared by ACGL's board of directors or a duly authorized committee of the board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears on the 15th day of February, May, August and November of each year, commencing on May 15, 2006. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the liquidation preference per annum.

On February 23, 2006 and May 3, 2006, ACGL's board of directors declared dividends with respect to the Series A Preferred Shares for the dividend period from February 1, 2006 through May 14, 2006, in an aggregate amount of \$4.6 million, to be payable out of lawfully available funds for the payment of dividends under Bermuda law on May 15, 2006 to holders of record as of May 1, 2006. In addition, effective June 30, 2006 and August 14, 2006, respectively, ACGL's board of directors declared additional partial dividends with respect to the outstanding Series A Preferred Shares for the partial dividend periods from May 15, 2006 through June 30, 2006 and July 1, 2006 through August 14, 2006, in aggregate amounts of \$2.0 million and \$2.0 million, respectively, in each case, to be payable out of lawfully available funds for the payment of dividends under Bermuda law on August 15, 2006 to holders of record as of August 1, 2006, unless determined otherwise by the Board or the Executive Committee of the Board on or prior to the applicable effective date.

#### 4. Segment Information

The Company classifies its businesses into two underwriting segments—insurance and reinsurance—and a corporate and other segment (non-underwriting). The Company's insurance and reinsurance operating segments each have segment managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company's chief operating decision makers, the President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. The Company determined its reportable operating segments using the management approach described in SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information.

Management measures segment performance based on underwriting income or loss. The Company does not manage its assets by segment and, accordingly, investment income is not allocated to each underwriting segment. In addition, other revenue and expense items are not evaluated by segment. The accounting policies of the segments are the same as those used for the preparation of the Company's consolidated financial statements. Inter-segment insurance business is allocated to the segment accountable for the underwriting results.

The insurance segment consists of the Company's insurance underwriting subsidiaries which primarily write on both an admitted and non-admitted basis. The insurance segment consists of eight specialty product lines: casualty; construction and surety; executive assurance; healthcare; professional liability; programs; property, marine and aviation; and other (consisting of collateralized protection business).

The reinsurance segment consists of the Company's reinsurance underwriting subsidiaries. The reinsurance segment generally seeks to write significant lines on specialty property and casualty reinsurance treaties. Classes of business include: casualty; marine and aviation; other specialty; property catastrophe; property excluding property catastrophe (losses on a single risk, both excess of loss and pro rata); and other (consisting of non-traditional and casualty clash business).

The corporate and other segment (non-underwriting) includes net investment income, other fee income, net of related expenses, other expenses incurred by the Company, interest expense, net realized gains or losses, net foreign exchange gains or losses and income taxes. In addition, results for the corporate and other segment include dividends on the Company's Series A Preferred Shares (see Note 3, Share Transactions).

The following tables set forth an analysis of the Company's underwriting income by segment, together with a reconciliation of underwriting income to net income available to common shareholders:

(U.S. dollars in thousands)	(Unaudited) Three Months Ended March 31, 2006		Total
	Insurance	Reinsurance	
Gross premiums written (1)	\$ 615,484	\$ 564,668	\$ 1,167,814
Net premiums written	397,254	476,465	873,719
Net premiums earned	\$ 380,254	\$ 381,347	\$ 761,601
Policy-related fee income	937		937
Other underwriting-related fee income	467	401	868
Losses and loss adjustment expenses	(248,002)	(220,176)	(468,178)
Acquisition expenses, net	(37,885)	(91,787)	(129,672)
Other operating expenses	(62,076)	(13,252)	(75,328)
Underwriting income	\$ 33,695	\$ 56,533	90,228
Net investment income			80,326
Net realized losses			(3,383)
Other expenses			(7,649)
Interest expense			(5,555)
Net foreign exchange losses			(10,253)
Income before income taxes			143,714
Income tax expense			(11,424)
<b>Net income</b>			132,290
Preferred dividends			(2,667)
<b>Net income available to common shareholders</b>			\$ 129,623
<b>Underwriting Ratios</b>			
Loss ratio	65.2%	57.7%	61.5%
Acquisition expense ratio (2)	9.7%	24.1%	16.9%
Other operating expense ratio	16.3%	3.5%	9.9%
Combined ratio	91.2%	85.3%	88.3%

- (1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include \$0.8 million and \$11.5 million, respectively, of gross and net premiums written and \$0.9 million and \$12.8 million, respectively, of net premiums earned assumed through intersegment transactions.
- (2) The acquisition expense ratio is adjusted to include policy-related fee income.

(U.S. dollars in thousands)	Insurance	(Unaudited) Three Months Ended March 31, 2005 Reinsurance	Total