UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2003

OR

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

For the transition period from _____ to _____

Commission file number 0-15341

DONEGAL GROUP INC.

(Exact name of registrant as specified in its charter)

Delaware	23-2424711
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1195 River Road, Marietta, Pennsylvania	17547
(Address of principal executive offices)	(Zip code)

Registrant's telephone number, including area code: (888) 877-0600

Securities registered pursuant to Section 12(b) of the Act: None.

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

Class A Common Stock, $.01 par value

Class B Common Stock, $.01 par value

(Title of class)

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes [ ]. No [X].

On June 30, 2003, the aggregate market value (based on the closing sales prices on that date) of the voting stock held by non-affiliates of the Registrant was $41,317,014.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 9,809,352 shares of Class A Common Stock and 3,011,049 shares of Class B Common Stock were outstanding on February 20, 2004.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the Registrant's annual report to stockholders for the fiscal year ended December 31, 2003 are incorporated by reference into Parts I, II and IV of this report.

2. Portions of the Registrant's proxy statement relating to the annual meeting of stockholders to be held April 15, 2004 are incorporated by reference into Part III of this report.

DONEGAL GROUP INC.

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PART I

Item 1. Business.

General Development of Business.

We are a property and casualty insurance holding company whose insurance subsidiaries offer personal and commercial lines of insurance to businesses and individuals in 14 Mid-Atlantic and Southeastern states. We provide our policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline. At December 31, 2003, we had total assets of $602.0 million and stockholders' equity of $208.6 million. Our net income was $18.3 million for the year ended December 31, 2003 compared to $12.0 million for the year ended December 31, 2002.

Donegal Mutual Insurance Company (the "Mutual Company") owns approximately 42% of our Class A common stock and approximately 62% of our Class B common stock. The operations of our insurance subsidiaries are interrelated with the operations of the Mutual Company and, while maintaining the separate corporate existence of each company, our insurance subsidiaries and the Mutual Company conduct business together as the Donegal Insurance Group. As such, we share the same business philosophy, management, employees and facilities as the Mutual Company and offer the same types of insurance products.

Our growth strategy includes the acquisition of other insurance companies to expand our business in a given region or to commence operations in a new region. Our prior acquisitions have either taken the form of:

- a purchase of the stock of an existing stock insurance company; or
- a two-step acquisition of an existing mutual insurance company as follows:
  - First, a surplus note in the target mutual insurance company is purchased, a management agreement with the target mutual insurance company is entered into and our designees are appointed as a majority of the target mutual insurance company's board of directors.
  - Second, the mutual insurance company is demutualized. We acquire the stock of the resulting stock insurance company after the company has been restructured and its book of business has been reunderwritten to our satisfaction.

We believe that our ability to make direct acquisitions or to structure acquisitions through Mutual Company surplus note transactions provides us with flexibility that is a competitive advantage in seeking acquisitions. We also believe we have demonstrated our ability to acquire control of a troubled insurance company, reunderwrite its book of business, reduce its cost structure and return it to profitability. When the Mutual

Company makes a surplus note investment in another company, the financial results of that company are not consolidated with our financial results or those of the Mutual Company, and neither we nor the Mutual Company are responsible for the insurance obligations of that company.

Unless otherwise specifically stated, all information in this Form 10-K Annual Report is as of December 31, 2003.

Le Mars Insurance Company (“Le Mars”)

In June 2002, the Mutual Company consummated an affiliation with Le Mars. As part of this affiliation, the Mutual Company entered into a management agreement with Le Mars and acquired control of Le Mars through the appointment of five Mutual Company designees to Le Mars’ nine-member board of directors. At the time of the affiliation, the Mutual Company made a $4.0 million investment in Le Mars’ surplus and was issued a surplus note, which we refer to as the Le Mars Surplus Note.

On August 11, 2003, Le Mars’ board of directors adopted a plan of conversion to convert to a stock insurance company. The plan of conversion was approved by the policyholders of Le Mars on October 6, 2003, and, on October 7, 2003, the Insurance Commissioner of Iowa held a public hearing regarding approval of the plan of conversion. Following the November 2003 regulatory approval of the plan of conversion, we acquired Le Mars as of January 1, 2004 for approximately $12.6 million in cash.

Le Mars, which was organized under the laws of Iowa in 1901, operates as a property and casualty insurer in Iowa, Nebraska, Oklahoma and South Dakota. Personal lines coverages represent a majority of Le Mars’ premiums written, with the balance coming from farmowners and mercantile and service businesses. Le Mars’ largest lines of business are private passenger automobile liability and physical damage; its other principal lines are homeowners and commercial multi-peril. Le Mars had net premiums earned of $20.5 million in 2002 and $17.9 million in 2003. The statutory surplus and total admitted assets on a statutory basis of Le Mars as of December 31, 2003 were $12.0 million and $37.0 million, respectively.

The Peninsula Insurance Group (“Peninsula”)

On January 6, 2004, we purchased Peninsula Indemnity Company and The Peninsula Insurance Company, both of which are organized under Maryland law, with headquarters in Salisbury, Maryland from Folksamerica Holding Company, Inc., a part of the White Mountains Insurance Group, Ltd., for a price in cash equal to 107.5% of Peninsula’s GAAP stockholders’ equity as of the closing of the acquisition, or approximately $23.3 million.

Peninsula specializes in private passenger automobile coverages. Peninsula also writes homeowners, commercial multi-peril, workers’ compensation and commercial automobile coverages. Peninsula operates primarily in Maryland, Delaware and Virginia. For the years ended December 31, 2002 and 2003, Peninsula had net premiums earned of $29.7 million and $32.7 million, respectively. Peninsula’s stockholders’ equity and total admitted assets on a statutory basis as of December 31, 2003 were $19.5 million and $52.6 million, respectively. The Peninsula companies have an A.M. Best rating of A (Excellent).

On December 1, 2003, we completed an underwritten public offering of 3,450,000 shares of our Class A common stock, resulting in net proceeds of $59 million to us.

Financial Information About Industry Segments.

The Company has three segments, which consist of its investment function, its personal lines of insurance and its commercial lines of insurance. Financial information about these segments is set forth in Note 17 to the Consolidated Financial Statements incorporated by reference herein.

Narrative Description of Business.

Who We Are

We are a property and casualty insurance holding company whose insurance subsidiaries offer personal and commercial lines of insurance to small businesses and individuals in 14 Mid-Atlantic and Southeastern states. We provide our policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline.

We derive a substantial portion of our insurance business from smaller to mid-sized regional communities. We believe this focus provides us with competitive advantages in terms of local market knowledge, marketing, underwriting, claims servicing and policyholder service. At the same time, we believe we have cost advantages over many regional insurers because of our centralized accounting, administrative, investment, data processing and other services.

Strategy

Our annual premiums earned have increased from $117.5 million in 1998 to $196.8 million in 2003, a compound annual growth rate of 10.9%. Over the same time period, our combined ratio has consistently been more favorable than that of the property and casualty insurance industry as a whole. We seek to grow our business and enhance our profitability by:

- *Achieving underwriting profitability.*

We focus on achieving a combined ratio of less than 100%, and believe that underwriting profitability is a fundamental component of our long-term financial strength because it allows us to generate profits without relying on our investment income. We seek to enhance our underwriting results by carefully selecting the product lines we underwrite, minimizing our exposure to catastrophe-prone areas and continually evaluating our claims history to ensure the adequacy of our underwriting guidelines and product pricing. For our personal lines products, we insure standard and preferred risks primarily in private passenger automobile and homeowners lines. We have no exposure to asbestos, and limited exposure to other environmental liabilities. We seek to provide more than one policy to a given personal or commercial customer because this “account selling” strategy diversifies our risk and has historically improved our underwriting results. Finally, we use reinsurance to manage our exposure and limit our maximum net loss from large single risks or risks in concentrated areas. We believe these practices are key factors in our ability to maintain a combined ratio that has been traditionally more favorable than the combined ratio of the property and casualty insurance industry.

Our combined ratio and that of our industry for the years 1998 through 2003 are shown in the following table:

	1998	1999	2000	2001	2002	2003
Donegal GAAP combined ratio	100.1%	106.5%	101.8%	103.8%	99.6%	95.0%
Industry SAP combined ratio[1]	106.0	108.1	110.4	115.9	107.4	101.1

(1) As reported by A.M. Best.

- *Pursuing profitable growth by organic expansion within our traditional operating territories through developing and maintaining quality agency representation.*

We believe that continued expansion within our existing markets will be a key source of our continued premium growth, and maintaining an effective and growing network of independent agents is integral to our expansion. We seek to be among the top three insurers within each of our agencies for the lines of business we write by providing a consistent, competitive and stable market for our products. We believe that the consistency of our product offerings enables us to compete effectively for agents with other insurers whose product offerings fluctuate based on industry conditions. We offer our agents a competitive compensation program that rewards them for pursuing profitable growth on our behalf, and we provide them with ongoing support that enables them to better attract and service customers, including Internet-based information systems, training programs, marketing support and field visitations by our marketing personnel and senior management. Finally, we appoint agencies with a strong underwriting and growth track record. We believe that by carefully selecting, motivating and supporting our agency force, we will be able to drive continued long-term growth.

- *Acquiring property and casualty insurance companies to augment our organic growth in existing markets and to expand into new geographic regions.*

We have completed six acquisitions of property and casualty insurance companies since 1995. We believe we have an opportunity to continue our growth by selectively pursuing affiliations and acquisitions that meet our criteria. Our criteria include:

- Location in regions where we are currently conducting business or would like to conduct business;

- A mix of business similar to our business;

- Targeted premium volume between $20.0 million and $80.0 million; and
- Transaction terms that are fair and reasonable to us.

We believe that our affiliation with the Mutual Company assists us in pursuing affiliations with and subsequent acquisitions of other mutual companies because we have a strong understanding of the concerns and issues that mutual companies face. In particular, we have had success affiliating with and acquiring undercapitalized mutual companies by utilizing our strengths and financial position to improve their operations significantly post-affiliation. We generally evaluate a number of areas for operational improvement when considering acquisitions, including product underwriting, expenses, the cost of reinsurance and technology.

- *Focusing on expense controls and utilization of technology to increase our operating efficiency.*

We maintain stringent expense controls with direct involvement by our senior management. We consolidate all processing and administrative activities at our home office to realize operating synergies and better control expenses. We utilize technology to automate much of our underwriting to facilitate agency and policyholder communications on an efficient and cost-effective basis. In 2002, we completed a reorganization begun in 2001 that streamlined our operations and allowed us to operate more efficiently. As a result of our focus on expense control, we have reduced our expense ratio from 35.9% for 1998 to 30.2% for 2003. We have also increased our annual premium per employee, a measure of efficiency that we use to evaluate our operations, from approximately $470,000 in 1998 to approximately $700,000 in 2003.

- *Providing responsive and friendly customer and agent service to enable us to attract new policyholders and retain existing policyholders.*

We believe that excellent policyholder service is important to attracting new policyholders and retaining existing policyholders. We work closely with our agency force to provide a consistently responsive level of claims service, underwriting and customer support. We seek to respond expeditiously and effectively to address customer and agent inquiries, including working to:

- Quickly reply to information requests and policy submissions; and
- Promptly respond to and process claims.

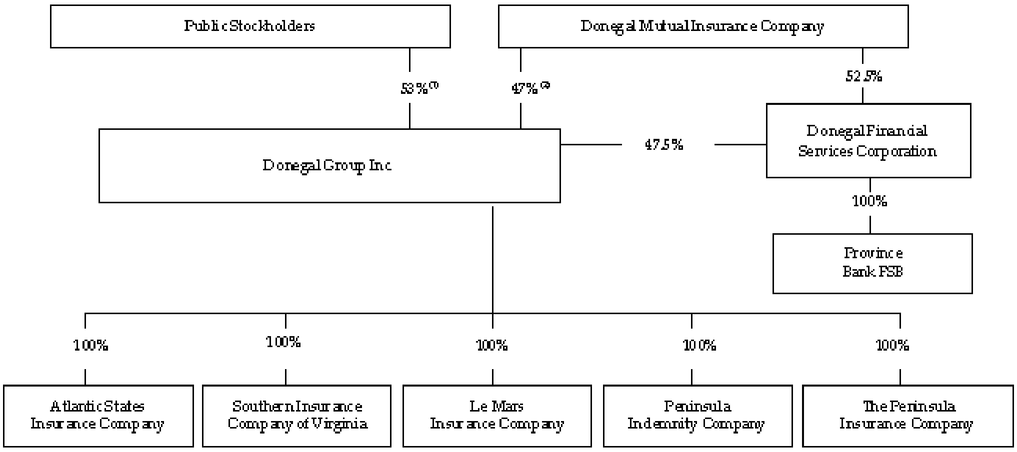
As a part of our focus on customer service, we conduct policyholder service surveys to evaluate the effectiveness of our support programs, and our management meets frequently with agency personnel to seek service improvement recommendations, react to service issues and better understand local market conditions.

- *Maintaining premium rate adequacy to enhance our underwriting results, while maintaining our existing book of business and preserving our ability to write new business.*

We are committed to maintaining discipline in our pricing by pursuing rate increases to maintain or improve our underwriting profitability without unduly affecting our ability to attract and retain customers. In addition to pursuing appropriate pricing, we take numerous actions to ensure that our premium rates are adequate relative to our level of underwriting risk. We review loss trends on a periodic basis to identify changes in the frequency and severity of our claims and to assess the adequacy of our rates and underwriting standards. We also carefully monitor and audit the key information that we use to price our policies, enabling us to receive an adequate level of premiums for our risk. For example, we inspect and perform loss control surveys on most of the risks we insure to determine adequacy of insurance to value, assess property conditions and identify any liability exposures. We audit the payroll data of our workers' compensation customers to verify that the assumptions we used to price a particular policy were accurate. By aggressively pursuing appropriate rate increases and thoroughly understanding the risks we insure, we are able to support our strategy of achieving consistent underwriting profitability.

Our Organizational Structure

We conduct most of our operations through our five insurance subsidiaries. We also own 47.5% of Donegal Financial Services Corporation ("DFSC"), a registered savings and loan holding company that owns Province Bank, a federal savings bank that began operations in 2000. The Mutual Company owns the remaining 52.5% of DFSC. While not yet profitable nor material to our operations, we believe Province Bank, with total assets of $50.4 million at December 31, 2003, will complement our product offerings. The following chart depicts our organizational structure, including our principal subsidiaries.

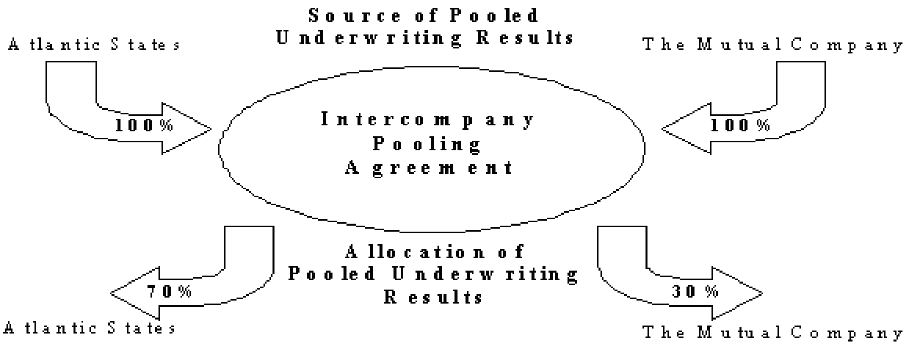


(1) Because of the different relative voting power of our Class A common stock and our Class B common stock, our public stockholders hold approximately 43% of the aggregate voting power.

(2) Because of the different relative voting power of our Class A common stock and our Class B common stock, the Mutual Company holds approximately 57% of the aggregate voting power.

Atlantic States, our largest insurance subsidiary, and the Mutual Company have a pooling agreement under which both companies are allocated a specified percentage of their combined underwriting results, excluding certain intercompany reinsurance assumed by the Mutual Company from our insurance subsidiaries. Under the terms of the pooling agreement, Atlantic States cedes its underwriting results to the Mutual Company. The Mutual Company in turn pools its underwriting results with the underwriting results of Atlantic States. The pooled underwriting results are then allocated 70% to Atlantic States and 30% to the Mutual Company. Pursuant to amendments to the pooling agreement since its commencement on October 1, 1986, the participation of Atlantic States in the underwriting results of the pool has gradually increased.

The following chart depicts our underwriting pool:



The pooling agreement may be amended or terminated at the end of any calendar year by agreement of the parties, subject to approval by the coordinating committee discussed below. The allocations of pool participation percentages between the Mutual Company and Atlantic States have been based on their approximate relative amounts of capital and surplus, expectations of future relative amounts of capital and surplus and our ability to raise capital for Atlantic States. We do not currently anticipate a further increase in Atlantic States' percentage of participation in the pool, nor do we intend to terminate the participation of Atlantic States in the pooling agreement.

The Mutual Company provides facilities, personnel and other services to us, and the related expenses are allocated between Atlantic States and the Mutual Company in relation to their relative participation in the pooling agreement. Southern reimburses the Mutual Company for its personnel costs and bears its proportionate share of information services costs based on its percentage of total written premiums of the Donegal Insurance Group. Expenses allocated to us under such agreements were $33.0 million in 2003.

Subsequent to receipt of approval by our board and the board of the Mutual Company, all agreements and all changes to existing agreements between the Mutual Company and us are subject to approval by a coordinating committee that is comprised of two of our board members who do not serve on the Mutual Company's board and two board members of the Mutual Company who do not serve on our board. In order to approve an agreement or a change in an agreement, our members on the coordinating committee must conclude that the agreement or change is fair to us and our stockholders, and the Mutual Company's members on the coordinating committee must conclude that the agreement or change is fair to the Mutual Company and its policyholders.

We believe our relationship with the Mutual Company offers us a number of competitive advantages, including:

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- Facilitating our stable management, consistent underwriting discipline, external growth and long-term profitability.
- Creating operational and expense synergies given the combined resources and operating efficiencies of the Mutual Company and us.
- Enhancing our ability to affiliate with and eventually acquire other mutual insurance companies.
- Producing a more uniform and stable underwriting result from year to year than we could achieve on our own.
- Giving Atlantic States the benefit of the underwriting capacity of the entire pool, rather than being limited by the amount of its own capital and surplus.

Acquisitions

The following table highlights our acquisition history since 1988:

Insurance Company Acquired	State	Year Acquired by Us	Method of Acquisition
Southern Mutual Insurance Company	Virginia	1988	Surplus note investment by the Mutual Company in 1984; demutualization in 1988; acquisition of stock by us in 1988.
Delaware Mutual Insurance Company(1)	Delaware	1995	Surplus note investment by the Mutual Company in 1993; demutualization in 1994; acquisition of stock by us in 1995.
Pioneer Mutual Insurance Company(1)	Ohio	1997	Surplus note investment by the Mutual Company in 1992; demutualization in 1993; acquisition of stock by us in 1997.
Southern Heritage Insurance Company(1)	Georgia	1998	Stock purchase in 1998.
Pioneer Mutual Insurance Company(1)	New York	2001	Surplus note investment by the Mutual Company in 1995; demutualization in 1998; acquisition of stock by us in 2001.

Insurance Company Acquired	State	Year Acquired by Us	Method of Acquisition
Le Mars Insurance Company	Iowa	2004	Surplus note investment by the Mutual Company in 2002; demutualization approved; acquisition of stock by us as of January 1, 2004.
Peninsula Insurance Group	Maryland	2004	Stock purchase on January 6, 2004.

(1) To reduce administrative and compliance costs and expenses, the designated entities were merged into one of our existing insurance subsidiaries.

We generally maintain the home office of an acquired company as part of our strategy to provide local marketing, underwriting and claims servicing even if the acquired company is merged into another subsidiary.

Distribution

Our insurance products are marketed primarily in the Mid-Atlantic and Southeast regions through approximately 1,200 insurance agencies that are comprised of approximately 6,800 agents. At December 31, 2003, the Donegal Insurance Group was licensed to do business in 15 states and operated in 14 states (Alabama, Arkansas, Connecticut, Delaware, Georgia, Louisiana, Maryland, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee and Virginia). We believe our relationships with our independent agents are valuable in identifying, obtaining and retaining profitable business. We maintain a stringent agency selection procedure that emphasizes appointing agencies with proven marketing strategies for the development of profitable business and we appoint only agencies with a strong underwriting and growth track record. We also regularly evaluate our agencies based on their profitability and performance in relation to our objectives. We seek to be among the top three insurers within each of our agencies for the lines of business we write.

The following table sets forth the percentage of our share of 2003 direct premiums written in each of the states where we conducted business in 2003:

Pennsylvania	58.3%
Virginia	14.6
Georgia	6.3
Maryland	5.7
Delaware	5.1
Ohio	4.3
North Carolina	1.7
New York	1.4
Other	2.6
Total	100.0%

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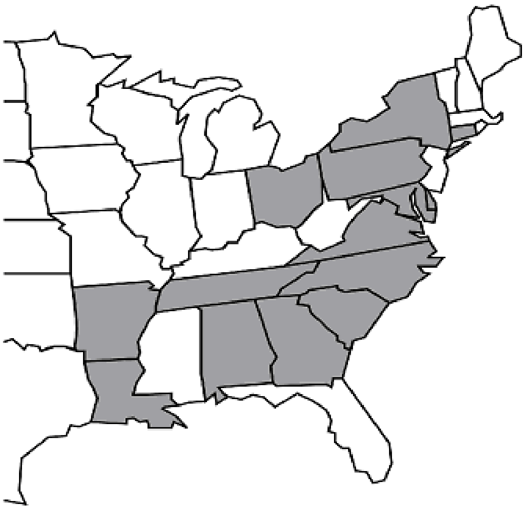

We believe we have developed a number of policies and procedures that enable us to attract, retain and motivate our agents. The consistency, competitiveness and stability of our product offerings assists us in competing effectively for agents with other insurers whose product offerings may fluctuate based upon industry conditions. We have developed a competitive contingent commission plan for agents, under which additional commissions are payable based upon the volume of premiums produced and the profitability of the business of the agency. We provide our agents ongoing support that enables them to better attract and retain customers, including Internet-based information systems, training programs, marketing support and field visitations by our marketing personnel and senior management. Finally, we encourage our independent agencies to focus on "account selling", or serving all of a particular insured's property and casualty insurance needs, which we believe generally results in more favorable loss experience than covering a single risk for an individual insured.

Products

Our personal lines of business consist primarily of automobile and homeowners insurance. Our commercial lines of business consist primarily of commercial automobile, commercial multi-peril and workers' compensation insurance. These types of insurance are described in greater detail below:

Personal

- Private passenger automobile – policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and protection against loss from damage to automobiles owned by the insured.

- Homeowners — policies that provide coverage for damage to residences and their contents from a broad range of perils, including, fire, lightning, windstorm and theft. These policies also cover liability of the insured arising from injury to other persons or their property while on the insured's property and under other specified conditions.

Commercial

- Commercial multi-peril – policies that provide protection to businesses against many perils, usually combining liability and physical damage coverages.
- Workers' compensation – policies purchased by employers to provide benefits to employees for injuries sustained during employment. The extent of coverage is established by the workers' compensation laws of each state.
- Commercial automobile – policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and protection against loss from damage to automobiles owned by the insured.

The following table sets forth the net premiums written by line of insurance for our business for the periods indicated:

	Year Ended December 31,					
	2001		2002		2003	
(dollars in thousands)	Amount	%	Amount	%	Amount	%
Net Premiums Written:						
Personal lines:						
Automobile	$ 74,396	42.0%	$ 84,643	43.5%	$ 86,644	41.9%
Homeowners	31,431	17.8	34,637	17.8	36,989	17.9
Other	5,796	3.3	6,497	3.4	6,753	3.2
Total personal lines	111,623	63.1	125,777	64.7	130,386	63.0
Commercial lines:						
Automobile	16,527	9.3	17,451	9.0	18,655	9.0
Workers' compensation	22,979	13.0	23,845	12.2	25,627	12.4
Commercial multi-peril	24,174	13.6	25,536	13.1	30,199	14.6
Other	1,725	1.0	1,895	1.0	2,114	1.0
Total commercial lines	65,405	36.9	68,727	35.3	76,595	37.0
Total business	$177,028	100.0%	$194,504	100.0%	$206,981	100.0%

Underwriting

Our underwriting department, which is divided into personal lines underwriting and commercial lines underwriting, evaluates and selects those risks that we believe will enable us to achieve an underwriting profit. Our underwriting department has significant interaction with our independent agents regarding our underwriting philosophy and underwriting guidelines and assists our research and development department in the development of quality products at competitive prices to promote growth and profitability.

In order to achieve underwriting profitability on a consistent basis, we:

- assess and select quality standard and preferred risks;
- adhere to disciplined underwriting and reunderwriting guidelines;
- inspect substantially all commercial lines risks and a substantial number of personal lines risks; and
- utilize various types of risk management and loss control services.

We also review our existing policies and accounts to determine whether those risks continue to meet our underwriting guidelines. If a given policy or account no longer meets our underwriting guidelines, we will take appropriate action regarding that policy or account, including raising premium rates or non-renewing the policy to the extent permitted by applicable law.

As part of our effort to maintain acceptable underwriting results, we conduct annual reviews of agencies that have failed to meet our underwriting profitability criteria. Our review process includes an analysis of the underwriting and reunderwriting practices of the agency, the completeness and accuracy of the applications submitted by the agency, the adequacy of the training of the agency’s staff and the agency’s record of adherence to our underwriting guidelines and service standards. Based on the results of this review process, our marketing and underwriting personnel develop, together with the agency, a plan to improve its underwriting profitability. We monitor the agency’s compliance with the plan, and take other measures as required in our judgment, including the termination of agencies that are unable to achieve acceptable underwriting profitability to the extent permitted by applicable law.

Claims

The management of claims is a critical component of our philosophy of underwriting profitability and is fundamental to our successful operations and our dedication to excellent service.

Our claims department rigorously manages claims to assure that legitimate claims are settled quickly and fairly and that questionable claims are identified for defense. In the majority of cases, claims are adjusted by our own personnel, whom we believe are experienced in our industry and who know our service philosophy. We provide various means of claims reporting on a 24-hour, seven day a week basis, including toll-free numbers and Internet reporting through our website. We strive to respond to notifications of claims promptly, generally within the day reported. We believe that by responding promptly to claims, we provide quality customer service and minimize the ultimate cost of the claims. We engage independent adjusters as needed to handle claims in areas in which the volume of claims is not sufficient to justify our hiring of internal claims adjusters. We also employ private investigators, structural experts and various outside legal counsel to supplement our in-house staff and assist us in the investigation of claims. We have a special investigative unit staffed by former law enforcement officers that attempts to identify and prevent fraud and abuse and to control questionable claims.

Our claims department management develops and implements policies and procedures for the establishment of adequate claim reserves. The management and staff of our claims department resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters. Our litigation and personal injury sections manage all claims litigation, and all branch office claims above $35,000 require home office review and settlement authorization. Claims adjusters are given reserving and settlement authority based upon their experience and demonstrated abilities. Larger or more complicated claims require consultation and approval of senior department management.

Our field office staff is supported by home office technical, litigation, material damage, subrogation and medical audit personnel who provide specialized claims support.

Liabilities for Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of what an insurer expects to pay to claimants, based on facts and circumstances then known, and it can be expected that the insurer's ultimate liability for losses and loss expenses will exceed or be less than such estimates. Our estimates of liabilities for losses and loss expenses are based on estimates of future trends and claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, we may learn additional facts regarding individual claims, and consequently it often becomes necessary to refine and adjust our estimates of our liability. We reflect any adjustments to our liabilities for losses and loss expenses in our operating results in the period in which the changes in estimates are made.

We maintain liabilities for the eventual payment of losses and loss expenses with respect to both reported and unreported claims. Liabilities for loss expenses are intended to cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. We base the amount of liability for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. We determine the amount of our liability for unreported claims and loss expenses on the basis of historical information by line of insurance. We account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. We closely monitor our liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our liabilities for losses are not discounted.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that the ultimate liability will not exceed our loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. As is the case for substantially all property and casualty insurance companies, we have found it necessary in the past to revise our estimated future liabilities for losses and loss expenses, and further adjustments could be required in the future. On the basis of our internal procedures, which analyze, among other things, our experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that adequate provision has been made for our liability for losses and loss expenses.

Differences between liabilities reported in our financial statements prepared on the basis of GAAP and our insurance subsidiaries' financial statements prepared on a statutory accounting basis ("SAP") result from anticipating salvage and subrogation recoveries for GAAP but not for SAP. These differences amounted to $8.2 million, $7.3 million and $7.2 million at December 31, 2001, 2002 and 2003, respectively.

The following table sets forth a reconciliation of our beginning and ending net liability for unpaid losses and loss expenses for the periods indicated:

	Year Ended December 31,		
(in thousands)	2001	2002	2003
Gross liability for unpaid losses and loss expenses at beginning of year	$156,476	$179,840	$210,692
Less reinsurance recoverable	53,767	65,296	79,584
Net liability for unpaid losses and loss expenses at beginning of year	102,709	114,544	131,108
Provision for net losses and loss expenses for claims incurred in the current year	110,143	122,434	126,693
Change in provision for estimated net losses and loss expenses for claims incurred in prior years	8,035	6,834	(450)
Total incurred	118,178	129,268	126,243
Net losses and loss payments for claims incurred during:			
The current year	63,290	67,656	72,187
Prior years	43,053	45,048	46,268
Total paid	106,343	112,704	118,455
Net liability for unpaid losses and loss expenses at end of year	114,544	131,108	138,896
Plus reinsurance recoverable	65,296	79,584	79,018
Gross liability for unpaid losses and loss expenses at end of year	$179,840	$210,692	$217,914

We recognized an increase (decrease) in the liability of losses and loss expenses for prior years of $8.0 million, $6.8 million and $(450,110) in 2001, 2002 and 2003, respectively. These developments are primarily attributable to variations from expected claim severity in the private passenger and commercial automobile liability, workers' compensation and commercial multiple peril lines of business.

The following table sets forth the development of our liability for net unpaid losses and loss expenses from 1993 to 2003, with supplemental loss data for 2002 and 2003. Loss data in the table includes business we are allocated from the Mutual Company as part of the pooling agreement.

"Net liability at end of year for unpaid losses and loss expenses" sets forth the estimated liability for net unpaid losses and loss expenses recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of net losses and loss expenses for claims arising in the current and all prior years that are unpaid at the balance sheet date, including losses incurred but not reported.

The "Net liability reestimated as of" portion of the table shows the reestimated amount of the previously recorded liability based on experience for each succeeding year. The estimate is increased or decreased as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 1993 liability has developed a redundancy after nine years, in that reestimated net losses and loss expenses are expected to be $12.8 million less than the estimated liability initially established in 1993 of $52.8 million.

The "Cumulative (excess) deficiency" shows the cumulative excess or deficiency at December 31, 2003 of the liability estimate shown on the top line of the corresponding column. An excess in liability means that the liability established in prior years exceeded actual net losses and loss expenses or were reevaluated at less than the original amount. A deficiency in liability means that the liability established in prior years was less than actual net losses and loss expenses or were reevaluated at more than the original amount.

The "Cumulative amount of liability paid through" portion of the table shows the cumulative net losses and loss expense payments made in succeeding years for net losses incurred prior to the balance sheet date. For example, the 1994 column indicates that as of December 31, 2003 payments equal to $49.3 million of the currently reestimated ultimate liability for net losses and loss expenses of $49.5 million had been made.

During 2000, 2001 and 2002, we experienced deficiencies in reserves for certain prior years. These deficiencies were primarily related to the workers' compensation, private passenger automobile, commercial automobile and commercial multiple-peril lines of business.

(in thousands)	Year Ended December 31, 1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net liability at end of year for unpaid losses and loss expenses	$ 52,790	$ 63,317	$ 75,372	$78,889	$80,256	$96,015	$ 99,234	$102,709	$114,544	$131,108	$138,896
Net liability reestimated as of:											
One year later	50,583	60,227	72,380	77,400	77,459	95,556	100,076	110,744	121,378	130,658	
Two years later	48,132	56,656	70,451	73,438	76,613	95,315	103,943	112,140	120,548		
Three years later	44,956	54,571	66,936	71,816	74,851	94,830	104,073	110,673			
Four years later	42,157	51,825	64,356	69,378	73,456	94,354	101,880				
Five years later	41,050	50,493	63,095	69,485	73,103	93,258					
Six years later	40,572	49,593	62,323	69,949	72,706						
Seven years later	39,991	49,504	62,534	69,415							
Eight years later	40,113	49,758	62,067								
Nine years later	40,131	49,539									
Ten years later	40,016										
Cumulative (excess) deficiency	$(12,774)	$(13,778)	$(13,305)	$ (9,474)	$ (7,550)	$ (2,757)	$ 2,646	$ 7,964	$ 6,004	$ (450)	
Cumulative amount of liability paid through:											
One year later	$ 16,126	$ 19,401	$ 24,485	$27,229	$27,803	$37,427	$ 39,060	$ 43,053	$ 45,048	$ 46,268	
Two years later	25,393	30,354	37,981	41,532	46,954	57,347	60,622	67,689	70,077		
Three years later	32,079	38,684	47,027	53,555	58,883	69,973	76,811	82,268			
Four years later	36,726	43,655	53,276	59,995	65,898	78,757	85,453				
Five years later	39,122	46,331	56,869	63,048	70,642	83,038					
Six years later	40,440	47,802	58,286	65,595	72,801						
Seven years later	40,903	48,520	59,160	66,976							
Eight years later	41,152	48,925	59,802								
Nine years later	39,877	49,288									
Ten years later	40,110										

	Year Ended December 31 1995	1996	1997	1998	1999	2000	2001	2002	2003
					(in thousands)				
Gross liability at end of year	$108,118	$113,346	$115,801	$136,727	$144,180	$156,476	$179,840	$210,692	$217,914
Reinsurance recoverable	32,746	34,457	35,545	40,712	44,946	53,767	65,296	79,584	79,018
Net liability at end of year	75,372	78,889	80,256	96,015	99,234	102,709	114,544	131,108	138,896
Gross reestimated liability – latest	83,265	101,136	104,328	127,657	154,481	172,905	195,097	214,635	
Reestimated recoverable – latest	21,198	31,721	31,622	34,399	52,601	62,232	74,549	83,977	
Net reestimated liability – latest	62,067	69,415	72,706	93,258	101,880	110,673	120,548	130,658	
Gross cumulative deficiency (excess)	(24,853)	(12,210)	(11,473)	(9,070)	10,301	16,429	15,257	3,943	

Technology

The Mutual Company owns our technology systems, and we use them pursuant to an intercompany agreement. Our technology systems consist of an integrated central processing computer, a series of server-based computer networks and various communications systems that allow our home office and branch offices to utilize the same systems for the processing of business. The Mutual Company maintains backup facilities and systems through a contract with a leading provider of computer disaster recovery sites, and these backup facilities and systems are tested on a regular basis. Atlantic States and Southern bear their proportionate share of information services expenses based on their percentages of the total net written premiums of the Donegal Insurance Group.

Our business strategy depends on the use, development and implementation of integrated technology systems. These systems enable us to provide a high level of service to our agents and policyholders by processing our business in a timely and efficient manner, communicating and sharing data with our agents, providing a variety of methods for the payment of premiums and allowing for the accumulation and analysis of information for our management.

We believe the implementation of our various technology systems has resulted in improved service to our agents and customers and increased efficiencies in the processing of our business, resulting in lower operating costs. Two of the key components of our integrated system are our agency interface system and our imaging system. Our agency interface system provides us with a high level of data sharing both to, and from, our agents' systems and also provides our agents with an integrated means of processing new business. Our imaging system reduces our need to handle paper files, while providing greater access to the same information by a variety of personnel.

Third Party Reinsurance

We and the Mutual Company use several different reinsurers, all of which, consistent with our requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating.

The external reinsurance we and the Mutual Company purchase includes:

- "excess of loss reinsurance," under which our losses are automatically reinsured, through a series of contracts, over a set retention ($300,000 for 2003), and

- "catastrophic reinsurance," under which we recover, through a series of contracts, between 95% and 100% of an accumulation of many losses resulting from a single event, including natural disasters ($3.0 million retention for 2003).

The amount of coverage provided under each of these types of reinsurance depends upon the amount, nature, size and location of the risk being reinsured.

Our principal third party reinsurance agreement in 2003 was a multi-line per risk excess of loss treaty with GMAC Re Corporation, Dorinco Reinsurance Company and Erie Insurance Group that provides coverage up to $1.0 million for both property and liability losses.

For property insurance, we also have excess of loss treaties that provide for additional coverage over the multi-line treaty up to $2.5 million per occurrence. For liability insurance, we have excess of loss treaties that provide for additional coverage over the multi-line treaty up to $40.0 million per occurrence. For workers' compensation insurance, we have excess of loss treaties that provide for additional coverage over the multi-line treaty up to $5.0 million on any one life.

We have property catastrophe coverage through a series of layered treaties up to aggregate losses of $80.0 million for the Donegal Insurance Group for any single event. This coverage is provided through as many as twenty reinsurers on any one treaty with no reinsurer taking more than 20.0% of any one contract.

On both property and casualty insurance, we and the Mutual Company purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by our respective treaty reinsurance.

Competition

The property and casualty insurance industry is highly competitive on the basis of both price and service. There are numerous companies competing for business in the geographic areas where we operate, many of which are substantially larger and have greater financial resources than we do, and no single company dominates. In addition, because our insurance products and those of the Mutual Company are marketed exclusively through independent insurance agencies, most of which represent more than one insurance company, we face competition within agencies as well as competition to retain qualified independent agencies.

Investments

Our return on invested assets is an important element of our financial results, and our investment strategy is to generate sufficient after-tax income on invested assets while minimizing credit risk through investments in high-quality securities. As a result, we seek to invest a high percentage of our funds in a diversified, highly rated and readily marketable group of fixed-maturity instruments. Our fixed-maturity portfolio consists of both taxable and tax-exempt securities. We maintain a sufficient portion of our portfolio in short-term securities, such as investments in commercial paper, to provide liquidity for the payment of claims and operation of our business and maintain a small percentage of our portfolio in equity securities.

At December 31, 2003, all of our debt securities were rated investment grade with the exception of one unrated obligation of $252,500 and the investment portfolio did not contain any mortgage loans or any non-performing assets.

The following table shows the composition of our debt securities investment portfolio (at carrying value), excluding short-term investments, by rating as of December 31, 2003:

(dollars in thousands)	December 31, 2003 Amount	December 31, 2003 Percent
Rating[1]		
U.S. Treasury and U.S. agency securities[2]	$125,520	40.30%
Aaa or AAA	100,278	32.19
Aa or AA	54,109	17.37
A	26,411	8.48
BBB	4,913	1.58
Not rated[3]	253	.08
Total	$311,484	100.00%

(1) Ratings assigned by Moody's Investors Services, Inc. or Standard & Poor's Corporation.

(2) Includes mortgage-backed securities of $25,882,579.

(3) Represents one unrated obligation of The Lancaster County Hospital Authority Mennonite Home Project that our management believes to be equivalent to investment grade securities with respect to repayment risk.

We invest in both taxable and tax-exempt securities as part of our strategy to maximize after-tax income. Our strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 30.9%, 41.0% and 41.6% of our debt securities investment portfolio at December 31, 2001, 2002 and 2003, respectively.

The following table shows the classification of our investments (at carrying value) at December 31, 2001, 2002 and 2003:

	December 31,					
	2001		2002		2003	
(dollars in thousands)	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Fixed maturities(1):						
Held to maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$23,809	7.9%	$12,641	3.8%	$ 29,131	6.9%
Canadian government obligation	499	0.2	499	0.2	499	0.1
Obligations of states and political subdivisions	24,982	8.3	33,892	10.2	45,188	10.7
Corporate securities	27,423	9.1	29,552	8.9	25,192	6.0
Mortgage-backed securities	8,610	2.9	10,118	3.0	13,041	3.1
Total held to maturity	85,323	28.4	86,702	26.1	113,051	26.8
Available for sale:						

(dollars in thousands)	December 31, 2001 Amount	2001 Percent of Total	2002 Amount	2002 Percent of Total	2003 Amount	2003 Percent of Total
U.S. Treasury securities and obligations of U.S. government corporations and agencies	68,975	23.0	58,287	17.5	70,507	16.7
Obligations of states and political subdivisions	55,147	18.3	81,446	24.5	84,386	20.0
Corporate securities	34,807	11.6	36,863	11.1	30,699	7.3
Mortgage-backed securities	14,790	4.9	18,136	5.5	12,841	3.1
Total available for sale	173,719	57.8	194,732	58.6	198,433	47.1
Total fixed maturities	259,042	86.2	281,434	84.7	311,484	73.9
Equity securities(2)	17,517	5.8	21,836	6.6	31,448	7.5
Short-term investments(3)	24,074	8.0	29,029	8.7	78,344	18.6
Total investments	$300,633	100.0%	$332,299	100.0%	$421,276	100.0%

(1) We account for our investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting For Certain Investments in Debt and Equity Securities." See Notes 1 and 3 to the Consolidated Financial Statements incorporated by reference herein. Fixed maturities classified as held to maturity are valued at amortized cost; those fixed maturities classified as available for sale are valued at fair value. Total fair value of fixed maturities classified as held to maturity was $86.9 million at December 31, 2001, $89.8 million at December 31, 2002 and $116.1 million at December 31, 2003. The amortized cost of fixed maturities classified as available for sale was $170.3 million at December 31, 2001, $187.5 million at December 31, 2002 and $192.1 million at December 31, 2003.

(2) Equity securities are valued at fair value. Total cost of equity securities was $16.6 million at December 31, 2001, $21.6 million at December 31, 2002 and $29.6 million at December 31, 2003.

(3) Short-term investments are valued at cost, which approximates market.

The following table sets forth the maturities (at carrying value) in our fixed maturity and short-term investment portfolio at December 31, 2001, December 31, 2002 and December 31, 2003:

(dollars in thousands)	December 31, 2001 Amount	2001 Percent of Total	2002 Amount	2002 Percent of Total	2003 Amount	2003 Percent of Total
Due in(1):						
One year or less	$ 37,120	13.1%	$ 47,034	15.1%	$ 92,396	23.7%
Over one year through three years	44,845	15.8	47,367	15.3	46,840	12.0
Over three years through five years	69,585	24.6	66,655	21.5	64,331	16.5
Over five years through ten years	96,642	34.1	64,271	20.7	73,057	18.7
Over ten years through fifteen years	7,573	2.7	52,517	16.9	81,016	20.8
Over fifteen years	3,951	1.4	4,365	1.4	6,306	1.6
Mortgage-backed securities	23,400	8.3	28,254	9.1	25,882	6.7
	$283,116	100.0%	$310,463	100.0%	$389,828	100.0%

(1) Based on stated maturity dates with no prepayment assumptions. Actual maturities will differ because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

As shown above, we held investments in mortgage-backed securities having a carrying value of $25.9 million at December 31, 2003. Our mortgage-backed securities consist primarily of investments in governmental agency balloon pools with stated maturities of five and seven years. The stated maturities of these investments limits our exposure to extension risk should interest rates rise and prepayments decline. We perform an analysis of the underlying loans when evaluating a mortgage-backed security for purchase, and we select those securities that we believe will provide a return that properly reflects the prepayment risk associated with the underlying loans.

Our investment results for the years ended December 31, 2001, 2002 and 2003 are shown in the following table:

	Year Ended December 31,		
(dollars in thousands)	**2001**	**2002**	**2003**
Invested assets(1)	$294,989	$316,466	$376,788
Investment income(2)	15,886	14,581	13,316
Average yield	5.3%	4.6%	3.5%

(1) Average of the aggregate invested amounts at the beginning and end of the period.

(2) Investment income is net of investment expenses and does not include realized investment gains or losses or provision for income taxes.

A.M. Best Rating

Currently, the A.M. Best rating of Atlantic States, Southern and the Mutual Company is A (Excellent), based upon their respective current financial condition and historical statutory results of operations and retrocessional agreements. We believe that our A.M. Best rating is an important factor in marketing our products to our agents and customers. A.M. Best's ratings are industry ratings based on a comparative analysis of the financial condition and operating performance of insurance companies as determined by their publicly available reports. A.M. Best's classifications are A++ and A+ (Superior), A and A- (Excellent), B++ and B+ (Very Good), B and B- (Good), C++ and C+ (Fair), C and C- (Marginal), D (Below Minimum Standards) and E and F (Liquidation). A.M. Best's ratings are based upon factors relevant to policyholders and are not directed toward the protection of investors. According to A.M. Best, an "Excellent" rating is assigned to those companies that, in A.M. Best's opinion, have achieved excellent overall performance when compared to the norms of the property and casualty insurance industry and have generally demonstrated a strong ability to meet policyholder and other contractual obligations.

Regulation

Insurance companies are subject to supervision and regulation in the states in which they transact business. Such supervision and regulation relate to numerous aspects of an insurance company's business and financial condition. The primary purpose of such supervision and regulation is the protection of policyholders. The extent of such regulation varies, but generally derives from state statutes that delegate regulatory, supervisory and administrative authority to state insurance departments. Accordingly, the authority of the state insurance departments includes the establishment of standards of solvency that must be met and maintained by insurers, the licensing to do business of insurers and agents, the nature of and limitations on investments, premium rates for property and casualty insurance, the provisions that insurers must make for current losses and future liabilities, the deposit of securities for the benefit of policyholders, the approval of policy forms, notice requirements for the cancellation of policies and the approval of certain changes in control. State insurance departments also conduct periodic examinations of the affairs of insurance companies and require the filing of annual and other reports relating to the financial condition of insurance companies.

In addition to state-imposed insurance laws and regulations, the National Association of Insurance Commissioners ("NAIC") has established a risk-based capital system for assessing the adequacy of statutory capital and surplus that augments the states' current fixed dollar minimum capital requirements for insurance companies. At December 31, 2003, our insurance subsidiaries and the Mutual Company each exceeded the minimum levels of statutory capital required by the risk-based capital rules. There can be no assurance that the statutory capital requirements applicable to our insurance subsidiaries or the Mutual Company will not increase in the future.

Generally, every state has guaranty fund laws under which insurers licensed to do business in the state can be assessed on the basis of premiums written by the insurer in that state in order to fund policyholder liabilities of insolvent insurance companies. Under these laws in general, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of policyholder claims against insolvent insurers. Atlantic States, Southern and the Mutual Company have made accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations. During 2001, 2002 and 2003, we incurred assessments totaling $1.3 million, $486,000 and $217,000, respectively, from the Pennsylvania Insurance Guaranty Association primarily relating to the insolvencies of three medical malpractice insurers and Reliance Insurance Company.

Most states have enacted legislation that regulates insurance holding company systems. Each insurance company in the holding company system is required to register with the insurance supervisory agency of its state of domicile and furnish information concerning the operations of companies within the holding company system that may materially affect the operations, management or financial condition of the insurers within the system. Pursuant to these laws, the respective insurance departments may examine our insurance subsidiaries or the Mutual Company at any time, require disclosure of material transactions by the holding company and require prior notice or prior approval of certain transactions, such as "extraordinary dividends" from the insurance subsidiaries to the holding company.

The Pennsylvania Insurance Holding Companies Act requires that all transactions within a holding company system to which an insurer is a party must be fair and reasonable and that any charges or fees for services performed must be reasonable. Any management agreement, service agreement, cost sharing arrangement and reinsurance agreement must be filed with the Pennsylvania Insurance Department and is subject to Department review. The pooling agreement and other intercompany reinsurance agreements were accordingly filed with the Pennsylvania Insurance Department. The Pennsylvania Insurance Department has never provided any notification of disapproval to any member of the Mutual Company or us.

Approval of the applicable insurance commissioner is also required prior to consummation of transactions affecting the control of an insurer. In some states, including Pennsylvania, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company creates a rebuttable presumption of a change in control. Pursuant to an order issued in April 2003, the Pennsylvania Insurance Department approved the Mutual Company's ownership of up to 70% of our outstanding Class A common stock and up to 100% of our outstanding Class B common stock. Insurance holding company laws also require notice to the applicable insurance commissioner of certain material transactions between an insurer and any person in its holding company system and, in some states, certain of such transactions cannot be consummated without the prior approval of the applicable insurance commissioner.

We are required to participate in involuntary insurance programs for automobile insurance, as well as other property and casualty insurance lines, in states in which we operate. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements (FAIR) plans, reinsurance facilities and windstorm plans. Legislation establishing these programs requires all companies that write lines covered by these programs to provide coverage, either directly or through reinsurance, for insureds who cannot obtain insurance in the voluntary market. The legislation creating these programs usually allocates a pro rata portion of risks attributable to such insureds to each company on the basis of direct premiums written or the number of automobiles insured in the particular state. Generally, state law requires participation in such programs as a condition to doing business. The loss ratio on insurance written under involuntary programs has traditionally been greater than the loss ratio on insurance written in the voluntary market.

Our insurance subsidiaries are restricted by the insurance laws of their respective states of domicile as to the amount of dividends or other distributions they may pay to us without the prior approval of the respective state regulatory authorities. Generally, the maximum amount that may be paid by an insurance subsidiary during any year after notice to, but without prior approval of, the insurance commissioners of these states is limited to a stated percentage of that subsidiary's statutory capital and surplus as of the end of the preceding year or the net income excluding realized capital gains of the subsidiary for the preceding year. As of December 31, 2003, the amount of dividends Atlantic States and Southern could pay us during 2004 without the prior approval of the various insurance commissioners was $13.3 million and $4.1 million, respectively.

The Mutual Company

The Mutual Company was organized in 1889. At December 31, 2003, the Mutual Company had admitted assets of $214.6 million and policyholders' surplus of $84.9 million. At December 31, 2003, the Mutual Company had no debt and, of its total liabilities of

$129.7 million, reserves for net losses and loss expenses accounted for $62.3 million and unearned premiums accounted for $33.3 million. Of the Mutual Company's investment portfolio of $135.5 million at December 31, 2003, investment-grade bonds accounted for $24.4 million and mortgages accounted for $4.2 million. At December 31, 2003, the Mutual Company owned 4,139,792 shares, or approximately 42%, of our Class A common stock, which were carried on the Mutual Company's books at $56.7 million, and 1,852,088 shares, or approximately 62%, of our Class B common stock, which were carried on the Mutual Company's books at $25.4 million. The foregoing financial information is presented on the statutory basis of accounting required by the NAIC Accounting Practices and Procedures Manual. The Mutual Company does not, nor is it required to, prepare financial statements in accordance with GAAP.

Donegal Financial Services Corporation

Because of our and the Mutual Company's ownership of DFSC, both we and the Mutual Company are regulated as unitary savings and loan holding companies. As such, both we and the Mutual Company are subject to regulation by the Office of Thrift Supervision, or the OTS, under the holding company provisions of the federal Home Owners' Loan Act, or HOLA. As a federally chartered and insured stock savings association, Province Bank is subject to regulation and supervision by the OTS, which is the primary federal regulator of savings associations, and by the Federal Deposit Insurance Corporation, in its role as federal deposit insurer. The primary purpose of the statutory and regulatory scheme is to protect depositors, the financial institutions and the financial system as a whole rather than the shareholders of financial institutions or their holding companies.

Transactions between a savings association and its "affiliates" are subject to quantitative and qualitative restrictions under Sections 23A and 23B of the Federal Reserve Act. Affiliates of a savings association include, among other entities, the savings association's holding company and non-banking companies that are under common control with the savings association. These affiliate restrictions apply to transactions between DFSC and Province Bank, on the one hand, and us and our insurance subsidiaries, on the other hand. These restrictions also apply to transactions among DFSC, Province Bank and the Mutual Company.

Cautionary Statement Regarding Forward-Looking Statements

This annual report and the documents incorporated by reference into this annual report contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies, reserves, profitability and business relationships and our other business activities during 2004 and beyond. In some cases, you can identify forward-looking statements by terms such as "may," "will," "should," "could," "would," "expect," "plan," "intend," "anticipate," "believe," "estimate," "objective," "project," "predict," "potential," "goal" and similar expressions. These forward-looking statements reflect our current views about future events, are based on our current assumptions and are subject to known and unknown risks and uncertainties that may cause our results, performance or achievements to differ materially from those anticipated in or implied by those statements. Many of the factors that will determine future events or achievements are beyond our ability to control or predict. Such factors may include those described under "Risk Factors." The forward-looking statements contained in this annual report reflect our views and assumptions only as of the date of this annual report. Except as required by law, we do not intend to, and assume no responsibility for, updating any forward-looking statements. We qualify all of our forward-looking statements by these cautionary statements.

Risk Factors

Risks Relating to Us and Our Business

Our operations are interrelated with those of the Mutual Company, which is our controlling stockholder, and potential conflicts exist between the best interests of our stockholders and the best interests of the policyholders of the Mutual Company.

The Mutual Company, which currently owns shares of our common stock generally entitling it to cast approximately 57% of the aggregate votes eligible to be cast by our stockholders at any meeting of stockholders, controls the election of the members of our board of directors, and four of the seven members of our board of directors are also members of the board of directors of the Mutual Company. These directors have a fiduciary duty to our stockholders, and also have a fiduciary duty to the policyholders of the Mutual Company. Our executive officers have the same positions with both the Mutual Company and us, and therefore have competing fiduciary duties. Certain potential and actual conflicts of interest arise from these separate fiduciary duties. Among these conflicts of interest are:

- We and the Mutual Company periodically review the percentage participation rate of Atlantic States in the underwriting pool.
- We and the Mutual Company must annually establish the terms of certain inter-company reinsurance agreements.
- We and the Mutual Company must make judgments about the allocation of shared expenses between the Mutual Company and us in accordance with various inter-company expense-sharing agreements.
- We may enter into other transactions and contractual relationships with the Mutual Company and its subsidiaries.

As a consequence, we and the Mutual Company have established a coordinating committee that consists of two of our directors who are not directors of the Mutual Company and two directors of the Mutual Company who are not members of our board of directors. Under our by-laws and those of the Mutual Company, any new agreement or transaction between the Mutual Company and us, as well as any proposed change to an existing agreement between the Mutual Company and us, must first be submitted to the Mutual Company's and our boards of directors for approval. If approved by both boards of directors, the proposed agreement or transaction, or the change in an existing agreement, must receive the approval of the coordinating committee. Coordinating committee approval is granted only if both of our coordinating committee members conclude that the new agreement or transaction or proposed change in an existing agreement is fair and equitable to us and our stockholders and both of the Mutual Company's coordinating committee members conclude that the new agreement or transaction or proposed change in an existing agreement is fair and equitable to the Mutual Company and its policyholders.

The Mutual Company has the ability to determine the outcome of all matters submitted for approval by our stockholders. The price of our Class A common stock may be adversely affected because of the Mutual Company's ownership of our Class A common stock and Class B common stock or by the difference in voting power between our Class A common stock and Class B common stock.

Each share of our Class A common stock has one-tenth of a vote per share and generally can vote as a separate class only on matters pertaining to the rights of holders of Class A common stock. Voting control of the Company is vested in the Mutual Company. The Mutual Company owns approximately 42% of our outstanding Class A common stock and approximately 62% of our outstanding Class B common stock and controls approximately 57% of the votes that may be cast on any matter submitted to a vote of our stockholders. The Mutual Company has sufficient voting control to:

- elect a majority of our board of directors, who in turn determines our management and policies; and
- control the outcome of any corporate transaction or other matter submitted to our stockholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets.

The interests of the Mutual Company may conflict with the interests of our other stockholders. In addition, the voting power of the Mutual Company may have a negative effect on the price of our Class A common stock.

Our results of operations could suffer if the Mutual Company were to experience unusually severe or frequent losses or were not able to price its premiums adequately.

Our insurance subsidiary, Atlantic States, participates in a pooling agreement with the Mutual Company, under which the parties share the underwriting results on substantially all of the property and casualty insurance business written by both companies. Under the terms of the pooling agreement, Atlantic States has a 70% share of the results of the pool and the Mutual Company has a 30% share of the results of the pool. The allocation of pool participation percentages between the Mutual Company and Atlantic States has been established based on the pool participants' relative amounts of capital and surplus, expectations of future relative amounts of capital and surplus and our ability to raise capital for Atlantic States. We do not expect the allocation to change in the foreseeable future.

Because of the pooled business allocated to us, our insurance operations are interrelated with the insurance operations of the Mutual Company, and our results of operations are dependent, in part, upon the underwriting results of the Mutual Company. Although the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for the participants in the pool than they would experience individually and to spread the risk of loss among the participants, if the Mutual Company experiences unusually severe or frequent losses or does not adequately price its premiums, our business, financial condition and results of operations could suffer.

We currently conduct business in a limited number of states, with a concentration of business in Pennsylvania and Virginia. Any single catastrophe occurrence or other condition affecting losses in these states could adversely affect our results of operations.

We conduct business in states located primarily in the Mid-Atlantic and Southeastern portions of the United States. A substantial portion of our business is private passenger and commercial automobile, homeowners and workers' compensation insurance in Pennsylvania and Virginia. While we actively manage our exposure to catastrophes through our underwriting process and the purchase of reinsurance, a single catastrophe occurrence, destructive weather pattern, general economic trend, terrorist attack, regulatory development or other condition affecting one or more of the states in which we conduct substantial business could materially adversely affect our business, financial condition and results of operations. Common catastrophic events include hurricanes, earthquakes, tornadoes, wind and hail storms, fires, explosions and severe winter storms.

Our business, financial condition and results of operations may be adversely affected if the independent agents that market our products do not maintain their current levels of premium writing, fail to comply with established underwriting guidelines or otherwise inappropriately market our products.

We market our insurance products solely through a network of approximately 1,200 independent insurance agencies, with approximately 6,800 agents. Our agency force is one of the most important components of our competitive profile. As a result, we are materially dependent upon these independent agents, each of whom has the authority to bind us to insurance contracts. To the extent that these independent agents' marketing efforts cannot be maintained at their current levels of volume and quality or they bind us to unacceptable insurance risks, fail to comply with our established underwriting guidelines or otherwise inappropriately market our products, our business, financial condition and results of operations will suffer.

Our business may not continue to grow and may be materially adversely affected if we cannot retain existing, and attract new, independent agents or if insurance consumers increase their use of other insurance delivery systems.

The continued growth of our business will depend materially upon our ability to retain existing, and attract new, independent agents. If independent agencies find it easier to do business with our competitors, it would be difficult for us to retain our existing business or attract new business. While we believe we maintain good relationships with our independent agents, we cannot be certain that these independent agents will continue to sell our products to the consumers they represent. Some of the factors that could adversely affect our ability to retain existing, and attract new, independent agents include:

- the significant competition among our competitors to attract independent agents;
- our intense and time-consuming process to select a new independent agent;
- our stringent criteria that require independent agents to adhere to consistent underwriting standards; and
- our ability to pay competitive and attractive commissions, bonuses and other incentives to independent agents as compensation for selling our products.

While we sell insurance solely through our network of independent agents, many of our competitors sell insurance through a variety of delivery methods, including independent agents, captive agencies, the Internet and direct sales. To the extent that individuals represented by our independent agents change their delivery system preference, our business, financial condition and results of operations may be adversely affected.

We are dependent on dividends from our insurance subsidiaries for the payment of our operating expenses, our debt service and dividends to stockholders; however, our insurance subsidiaries may be unable to pay dividends to us.

As a holding company, we rely primarily on dividends from our insurance subsidiaries as a source of funds to meet our corporate obligations. Payment of dividends by our insurance subsidiaries is subject to regulatory restrictions and depends on the surplus of our subsidiaries. From time to time, the NAIC and various state insurance regulators consider modifying the method of determining the amount of dividends that may be paid by an insurance company without prior regulatory approval. The maximum amount of dividends that Atlantic States and Southern, our insurance subsidiaries during 2003, can pay us in 2004 without prior regulatory approval is approximately $17.4 million. In addition, state insurance regulators have broad discretion to limit the payment of dividends by our insurance subsidiaries in the future. The ability of our insurance subsidiaries to pay dividends to us may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus that could affect our ratings, competitive position, the amount of premiums that we can write and our ability to pay future dividends.

If the A.M. Best rating assigned to the Mutual Company or our insurance subsidiaries is significantly downgraded, our competitive position would be adversely affected.

Industry ratings are a factor in establishing the competitive position of insurance companies. Our insurance subsidiaries and the Mutual Company are rated by A.M. Best, an industry-accepted source of insurance company financial strength ratings. A.M. Best ratings are specifically designed to provide an independent opinion of an insurance company's financial health and its ability to meet ongoing obligations to policyholders. We believe that the financial strength rating of A.M. Best is material to our insurance operations. Currently, the Mutual Company, Atlantic States and Southern each have an A (Excellent) rating from A.M. Best. If the Mutual Company or any of our insurance subsidiaries were to be downgraded by A.M. Best, it would adversely affect our competitive position and make it more difficult for us to market our products and retain our existing policyholders.

Our strategy to grow in part through acquisitions of smaller insurance companies exposes us to a number of risks that could adversely affect our results of operations and financial condition.

The acquisition of smaller and undercapitalized insurance companies involves a number of risks that could adversely affect our results of operations and financial condition. The risks associated with the acquisition of this type of company include:

- the inadequacy of reserves for loss and loss expenses;
- the need to supplement management with additional experienced personnel;
- conditions imposed by regulatory agencies that make the realization of cost-savings through integration of operations more difficult;
- a need for additional capital that was not anticipated at the time of the acquisition; and
- the use of more of our management's time than was originally anticipated.

If we cannot obtain sufficient capital to fund our organic growth and acquisitions, we may not be able to expand our business.

Our strategy is to expand our business through organic growth and through strategic acquisitions of regional insurance companies. We will require additional capital in the future to support this objective. If we are unable to obtain sufficient capital on satisfactory terms and conditions, we may not be able to expand our business or make future acquisitions. Our ability to obtain additional financing will depend on a number of factors, many of which are beyond our control. For example, we may not be able to obtain additional financing because we may already have substantial debt at the time or because we do not have sufficient cash flow to service or repay our existing or additional debt. In addition, any equity capital we obtain in the future could be dilutive to our existing stockholders.

Many of our competitors are financially stronger than we are and may be able to offer lower-priced products with which we may be unable to compete.

The property and casualty insurance industry is intensely competitive. Competition is based on many factors, including the perceived financial strength of the insurer, premiums charged, policy terms and conditions, policyholder service, reputation and experience. We compete with many regional and national property and casualty insurance companies, including direct sellers of insurance products, insurers having their own agency organizations and other insurers represented by independent agents. Many of these insurers are better capitalized than we are, have substantially greater financial, technical and operating resources and have equal or higher ratings from A.M. Best. In addition, our competition may become increasingly better capitalized in the future as the traditional barriers between insurance companies, banks and other financial institutions erode and as the property and casualty insurance industry continues to consolidate.

The greater capitalization of many of our competitors enables them to operate with lower profit margins and, therefore, allows them to market their products more aggressively, take advantage more quickly of new marketing opportunities and offer lower premium rates. We may not be able to maintain our current competitive position in the markets in which we operate if our competitors offer prices on products that are lower than the prices we can offer. Moreover, if our competitors lower the price of their products and we meet their pricing, our profit margins and revenues may be reduced and our ratios of claims and expenses to premiums may increase, which may materially adversely affect our business, financial condition and results of operations.

Because our investment portfolio is made up primarily of fixed-income securities, our investment income and the fair value of our investment portfolio could suffer as a result of a number of factors.

We invest the premiums we receive from our policyholders and maintain an investment portfolio that consists primarily of fixed-income securities. The management of our investment portfolio is an important component of our profitability because a significant portion of our operating income is generated from the income we receive on our invested assets. The quality and/or yield of our portfolio may be affected by a number of factors, including the general economic and business environment, changes in the credit quality of the issuers of the fixed-income securities we own, changes in market conditions and regulatory changes. The fixed-income securities we own are issued primarily by domestic entities and are backed either by the credit or collateral of the underlying issuer. Factors such as an economic downturn, a regulatory change pertaining to a particular issuer's industry, a significant deterioration in the cash flows of the issuer or a change in the issuer's marketplace may adversely affect our ability to collect principal and interest from the issuer.

Our investments are also subject to risk resulting from interest rate fluctuations. Increasing interest rates or a widening in the spread between interest rates available on United States Treasury securities and corporate debt or asset-backed securities, for example, will typically have an adverse impact on the market values of the fixed-rate securities in our investment portfolio. If interest rates decline, we generally achieve a lower overall rate of return on investments of cash generated from our operations. In addition, in the event that investments are called or mature in a declining interest rate environment, we may be unable to reinvest the proceeds in securities with comparable interest rates. Changes in interest rates may reduce both our profitability and our return on invested capital.

We are dependent on our key personnel, and the loss of any member of our senior management could negatively affect the implementation of our business strategy and achievement of our growth objectives.

The loss of, or failure to attract, key personnel could significantly impede our financial plans, growth, marketing and other objectives. Our success depends to a substantial extent on the ability and experience of our senior management. We believe that our future success will depend in large part on our ability to attract and retain additional skilled and qualified personnel and to expand, train and manage our employees. We may not be successful in doing so, because the competition for experienced personnel in the insurance industry is intense. We do not have employment agreements with our key personnel, all of whom are employed by the Mutual Company.

Recently enacted and proposed changes in securities laws and regulations are likely to increase our costs.

The Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), which became law in July 2002, required changes in our corporate governance, public disclosure and compliance practices. Sarbanes-Oxley also required the Securities and Exchange Commission (the “SEC”), to promulgate new rules on a variety of corporate governance and disclosure subjects. In addition to final rules and rule proposals already made, the Nasdaq National Market^{SM} (“Nasdaq”) has adopted revisions to its requirements for companies listed on Nasdaq, like us. We expect these developments to increase our legal and financial compliance costs.

We also expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These developments could make it more difficult for us to attract and retain additional members of our board of directors, particularly to serve on our audit committee, and additional executive officers.

The reinsurance agreements on which we rely do not relieve us from liability to our policyholders, and we face a risk of non-payment from our reinsurers and the non-availability of reinsurance in the future.

We rely on reinsurance agreements to limit our maximum net loss from large single risks or risks in concentrated areas, and to increase our capacity to write insurance. Although the reinsurance we maintain provides that the reinsurer is liable to us, our reinsurance does not relieve us from liability to our policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable to us under the terms of its reinsurance agreement with us, we remain liable for such losses. As of December 31, 2003, we had approximately $16.0 million of reinsurance receivables from third party reinsurers for paid and unpaid losses for which we believe we are entitled to reimbursement. The insolvency or inability to make timely payments by our reinsurers under the terms of our reinsurance agreements would adversely affect our results of operations.

In addition, we face a risk of the non-availability of reinsurance or an increase in reinsurance costs that could adversely affect our ability to write business or our results of operations. Market conditions beyond our control, such as the amount of surplus in the reinsurance market and natural and man-made catastrophes, affect the availability and cost of the reinsurance we purchase. We cannot assure you that reinsurance will remain available to us to the same extent and on substantially the same terms and rates as it is currently available. If we are unable to maintain our current level of reinsurance or purchase new reinsurance protection in amounts that we consider sufficient, we would either have to be willing to accept an increase in our net retention or reduce our insurance writings, and our business, financial condition and results of operations could be adversely affected.

Risks Relating to the Property and Casualty Insurance Industry

We face significant exposure to terrorism.

As a result of the September 11, 2001 terrorist attacks, the insurance industry has been compelled to re-examine policy terms and conditions and to address the potential for future threats of terrorist attacks and resulting losses. Our personal and commercial property and casualty insurance policies are not priced to cover the risk of terrorist attacks and losses such as those suffered in the World Trade Center terrorist attack. Therefore, we have exposure to terrorism under the lines of insurance products that we offer. The Terrorism Risk Insurance Act of 2002 may reduce the impact of future losses as a result of terrorism in connection with commercial insurance products we offer; however, because of the uncertainty regarding the application of the Terrorism Risk Insurance Act, the amount of losses we may be required to retain as a result of terrorism may result in a material adverse effect on our business, financial condition and results of operations. The Terrorism Risk Insurance Act is scheduled to expire on December 31, 2005, so it will not provide coverage beyond that time unless it is extended. The Terrorism Risk Insurance Act does not cover the personal insurance products we offer, and state regulators have not approved exclusions for acts of terrorism in our personal insurance products. Therefore we could incur large unexpected losses from the personal insurance policies that we issue, which could have a material adverse effect on our business, financial condition and results of operations.

Industry trends, such as increased litigation against the insurance industry and individual insurers, the willingness of courts to expand covered causes of loss, rising jury awards, increasing medical costs and the escalation of loss severity may contribute to increased costs and to the deterioration of our reserves.

Loss severity in our industry has continued to increase in recent years, principally driven by larger court judgments and increasing medical costs. In addition, many legal actions and proceedings have been brought on behalf of classes of complainants, which can increase the size of judgments. The propensity of policyholders and third party claimants to litigate and the willingness of courts to expand causes of loss and the size of awards may render our loss reserves inadequate for current and future losses if we become subject to litigation.

Loss or significant restriction of the use of credit scoring in the pricing and underwriting of our personal insurance products could reduce our future profitability.

We use credit scoring as a factor in making risk selection and pricing decisions where allowed by state law for our personal insurance products. Recently, some consumer groups and regulators have questioned whether the use of credit scoring unfairly discriminates against people with low incomes, minority groups and the elderly. These consumer groups and regulators are calling for the prohibition or restriction on the use of credit scoring in underwriting and pricing. Laws or regulations enacted in a number of states that significantly curtail the use of credit scoring in the underwriting process could reduce our future profitability.

Changes in applicable insurance laws or regulations or changes in the way regulators administer those laws or regulations could materially adversely change our operating environment and increase our exposure to loss or put us at a competitive disadvantage.

Property and casualty insurers are subject to extensive supervision in the states in which they do business. This regulatory oversight includes, by way of example, matters relating to licensing and examination, rate setting, market conduct, policy forms, limitations on the nature and amount of certain investments, claims practices, mandated participation in involuntary markets and guaranty funds, reserve adequacy, insurer solvency, transactions between affiliates, the amount of dividends that may be paid and restrictions on underwriting standards. Such regulation and supervision are primarily for the benefit and protection of policyholders and not for the benefit of stockholders. For instance, we are subject to involuntary participation in specified markets in various states in which we operate, and the rate levels we are permitted to charge do not always correspond with our underlying costs associated with the coverage we have issued.

The NAIC and state insurance regulators are re-examining existing laws and regulations, specifically focusing on insurance company investments, issues relating to the solvency of insurance companies, risk-based capital guidelines, restrictions on terms and conditions included in insurance policies, certain methods of accounting, reserves for unearned premiums, losses and other purposes, interpretations of existing laws and the development of new laws. Changes in state laws and regulations, as well as changes in the way state regulators view related party transactions in particular, could materially change our operating environment and have an adverse effect on our business.

The state insurance regulatory framework recently has come under increased federal scrutiny. Congress is considering legislation that would create an optional federal charter for insurers. Federal chartering has the potential to create an uneven playing field for insurers by subjecting federally-chartered and state-chartered insurers to different regulatory requirements. Federal chartering also raises the specter of a matrix of regulation and costly duplicative, or conflicting, federal and state requirements. In addition, if federal legislation repeals the partial exemption for the insurance industry from federal antitrust laws, it would make it extremely difficult for insurers to compile and share loss data and predict future loss costs, which is an important part of cost-based pricing for insurers. If the ability to collect this data were removed, then the predictability of future loss costs, and hence, the reliability of our pricing, would be greatly undermined.

If certain state regulators, legislators and special interest groups are successful in attempts to reduce, freeze or set rates for insurance policies, especially automobile policies, at levels that do not, in our management's view, correspond with underlying costs, our results of operations will be adversely affected.

From time to time, the automobile insurance industry in particular has been under pressure from certain state regulators, legislators and special interest groups to reduce, freeze or set rates at levels that do not, in the view of our management, correspond with underlying costs, including initiatives to roll back automobile and other personal lines rates. This activity may in the future adversely affect the profitability of our automobile insurance line of business in various states because increasing costs of litigation and medical treatment, combined with rising automobile repair costs, continue to increase our cost of providing automobile insurance coverage that we may not be able to offset by increasing the rates for our automobile insurance products. Adverse legislative and regulatory activity constraining our ability to price automobile insurance coverage adequately may occur in the future. The impact of the automobile insurance regulatory environment on our results of operations in the future is not predictable.

We are subject to assessments, based on our market share in a given line of business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies; these assessments could significantly affect our financial condition.

We are obligated to pay assessments under the guaranty fund laws of the various states in which we are licensed. Generally, under these laws, we are subject to assessment, depending upon our market share of a given line of insurance business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies in those states. The number and magnitude of future insurance company failures in the states in which we conduct business cannot be predicted, but resulting assessments could significantly affect our business, financial condition and results of operations. We are currently being assessed at the maximum level permitted by Pennsylvania law for several of our lines of business, and we expect that we will continue to be assessed by Pennsylvania at the maximum level for these business lines for a number of years.

We must establish premium rates and loss and loss expense reserves from forecasts of the ultimate costs expected to arise from risks underwritten during the policy period, and our profitability could be adversely affected to the extent our premium rates or reserves are too low.

One of the distinguishing features of the property and casualty insurance industry is that its products are priced before its costs are known, as premium rates are generally determined before losses are reported. Accordingly, we must establish premium rates from forecasts of the ultimate costs we expect to arise from risks we have underwritten during the policy period, and our premium rates may not be adequate to cover the ultimate losses incurred. Further, we must establish reserves for losses and loss expenses based upon estimates involving actuarial and statistical projections at a given time of what we expect to be our ultimate liability, and it is possible that our ultimate liability will exceed these estimates because of the future development of known losses, the existence of losses that have occurred but are currently unreported and larger than historical settlements on pending and unreported claims. The process of estimating reserves is inherently judgmental and can be influenced by factors that are subject to variation. If the premium rates or reserves we establish are not sufficient, our business, financial condition and results of operations may be adversely impacted.

The cyclical nature of the property and casualty insurance industry may reduce our revenues and profit margins.

The property and casualty insurance industry is highly cyclical, and individual lines of business experience their own cycles within the overall insurance industry cycle. Premium rate levels are related to the availability of insurance coverage, which varies according to the level of surplus in the insurance industry. The level of surplus in the industry varies with returns on invested capital and regulatory barriers to withdrawal of surplus. Increases in surplus have generally been accompanied by increased price competition among property and casualty insurers. If we find it necessary to reduce premiums or limit premium increases due to these competitive pressures on pricing, we may experience a reduction in our profit margins and revenues, an increase in our ratios of losses and expenses to premiums and, therefore, lower profitability.

Risks Relating to Our Class A Common Stock

The price of our Class A common stock may be adversely affected by its low trading volume.

Our Class A common stock has limited trading liquidity. Reported average daily trading volume in our Class A common stock for the year ended December 31, 2003, was approximately 15,000 shares. This limited trading liquidity subjects our shares of Class A common stock to greater price volatility.

The market price of our Class A common stock may be adversely affected by future sales of a substantial number of shares of our Class A common stock or Class B common stock or the availability of such shares for sale.

The sale, or the availability for sale, of a significant number of shares of our Class A common stock or Class B common stock could adversely affect the prevailing market prices of our Class A common stock and could impair our ability to raise capital through future sales of our equity securities. As of February 20, 2004, we had outstanding 9,809,352 shares of our Class A common stock and 3,011,049 shares of our Class B common stock. Apart from the shares held by the Mutual Company, all of our outstanding shares of Class A common stock and Class B common stock are freely tradeable without restrictions under the Securities Act. Sales of a substantial number of shares of our Class A common stock or Class B common stock by the Mutual Company could cause the price of our Class A common stock to fall.

The Mutual Company's ownership of our stock, provisions of our certificate of incorporation and by-laws and certain state laws make it unlikely anyone could acquire control of us unless the Mutual Company were in favor of the change of control.

The Mutual Company's ownership of our Class A common stock and Class B common stock, certain provisions of our certificate of incorporation and by-laws and the insurance laws and regulations of Pennsylvania and Virginia could delay or prevent the removal of members of our board of directors and could make more difficult a merger, tender offer or proxy contest involving us to succeed, even if such events were beneficial to the interest of our stockholders other than the Mutual Company. These factors could also discourage a third party from attempting to acquire control of us. The classification of our board of directors could also have the effect of delaying or preventing a change in control of us.

In addition, we have authorized 2,000,000 shares of series preferred stock that we could issue without further stockholder approval and upon such terms and conditions, and having such rights, privileges and preferences, as our board of directors may determine and that may make it difficult for a third party to acquire control of us. We have no current plans to issue any preferred stock. Moreover, the Delaware General Corporation Law contains certain provisions that prohibit certain business combination transactions under certain circumstances. In addition, state insurance laws and regulations generally prohibit any persons from acquiring a 10% or greater interest in an insurance company without the prior approval of the state insurance commissioner of the state where the insurer is domiciled.

Available Information

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports are available without charge on our website, www.donegalgroup.com, as soon as reasonably practicable after they are filed electronically with the SEC. Our Code of Business Conduct and Ethics, and the charters of our Audit Committee and our Nominating Committee are available on our website. Upon request to our Corporate Secretary, printed copies are also available. We are providing the address to our Internet site solely for the information of investors. We do not intend the reference to our website address to be an active link or to otherwise incorporate the contents of the website into this report.

Item 2. Properties.

We and Atlantic States share headquarters with the Mutual Company in a building owned by the Mutual Company. The Mutual Company charges us for an appropriate portion of the building expenses under an inter-company allocation agreement that is consistent with the terms of the pooling agreement. The headquarters of the Mutual Company has approximately 172,600 square feet of office space. Southern owns a facility of approximately 10,000 square feet in Glen Allen, Virginia. Le Mars owns a facility of approximately 25,500 square feet in Le Mars, Iowa and Peninsula owns a facility of approximately 14,600 square feet in Salisbury, Maryland.

Item 3. Legal Proceedings.

We are a party to numerous lawsuits arising in the ordinary course of our insurance business. We believe that the resolution of these lawsuits will not have a material adverse effect on our financial condition or results of operations.

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

No matter was submitted to a vote of holders of our Class A common stock or Class B common stock during the fourth quarter of 2003.

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Executive Officers of the Company

The following table sets forth information regarding the executive officers of the companies that comprise the Donegal Insurance Group, each of whom has served with us for more than 15 years:

Name	Age	Position
Donald H. Nikolaus	61	President and Chief Executive Officer of the Mutual Company since 1981; President and Chief Executive Officer of the Company since 1986.
Ralph G. Spontak	51	Senior Vice President of the Mutual Company and the Company since 1991; Chief Financial Officer of the Mutual Company since 1983 and of the Company since 1986 and Secretary of the Mutual Company and the Company since 1988.
Robert G. Shenk	50	Senior Vice President, Claims, of the Mutual Company since 1997; Vice President, Claims, of the Mutual Company from 1992 to 1997 and Manager, Casualty Claims, of the Mutual Company from 1985 to 1992.
Cyril J. Greenya	59	Senior Vice President, Underwriting, of the Mutual Company since 1997, Vice President, Commercial Underwriting, of the Mutual Company from 1992 to 1997 and Manager, Commercial Underwriting of the Mutual Company from 1983 to 1992.
Daniel J. Wagner	43	Treasurer of the Mutual Company and the Company since 1993; Controller of the Mutual Company and the Company from 1988 to 1993.

PART II

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

The response to this Item is incorporated in part by reference to page 32 of our Annual Report to Stockholders for the year ended December 31, 2003, which is included as Exhibit (13) to this Form 10-K Report. As of February 20, 2004, we had approximately 633 holders of record of our Class A common stock and 478 holders of record of our Class B common stock. We declared dividends of $0.43 per share on our Class A common stock and $0.39 per share on our Class B common stock in 2003 and $.40 per share on our Class A common stock and $.36 per share on our Class B common stock in 2002.

During the year ended December 31, 2003, we did not repurchase any of our Class A common stock or Class B common stock. During 2004, we may repurchase shares of our Class B common stock from time to time in open market transactions in accordance with SEC Rule 10b-18 or in private transactions.

Item 6. Selected Financial Data.

The response to this Item is incorporated by reference to page 8 of our Annual Report to Stockholders for the year ended December 31, 2003, which is included as Exhibit (13) to this Form 10-K Report.

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

The response to this Item is incorporated by reference to pages 10 through 15 of our Annual Report to Stockholders for the year ended December 31, 2003, which is included as Exhibit (13) to this Form 10-K Report.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

We are exposed to the impact of interest rate changes, changes in market values of investments and to credit risk.

In the normal course of business, we employ established policies and procedures to manage our exposure to changes in interest rates, fluctuations in the fair market value of our debt and equity securities and credit risk. We seek to mitigate these risks by various actions described below.

Interest Rate Risk

Our exposure to market risk for a change in interest rates is concentrated in our investment portfolio. We monitor this exposure through periodic reviews of asset and liability positions. Estimates of cash flows and the impact of interest rate fluctuations relating to our investment portfolio are monitored regularly. Generally, we do not hedge our exposure to interest rate risk because we have the capacity to, and do, hold fixed maturity investments to maturity.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates are as follows:

	As of December 31, 2003	
(amounts in thousands)	Principal cash flows	Weighted-average interest rate
Fixed maturities and short-term investments:		
2004	$ 92,194	1.74%
2005	13,337	5.86
2006	32,989	4.81
2007	31,236	4.63
2008	40,075	4.01
Thereafter	169,209	4.85
Total	$379,040	
Market Value	$392,910	
Debt:		
2033	$ 25,774	5.17%
Total	$ 25,774	
Fair Value	$ 25,774	

Actual cash flows from investments may differ from those stated as a result of calls and prepayments.

Equity Price Risk

Our portfolio of marketable equity securities, which is carried on the consolidated balance sheets at estimated fair value, has exposure to price risk, the risk of potential loss in estimated fair value resulting from an adverse change in prices. Our objective is to earn competitive relative returns by investing in a diverse portfolio of high-quality, liquid securities.

Credit Risk

Our objective is to earn competitive returns by investing in a diversified portfolio of securities. Our portfolio of fixed-maturity securities and, to a lesser extent, our short-term investments are subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing up front underwriting analysis and through regular reviews by our investment staff. The fixed maturity investments are also maintained between minimum and maximum percentages of invested assets.

We provide property and liability insurance coverages through independent insurance agencies located throughout our operating areas. The majority of this business is billed directly to the insured, although a portion of our commercial business is billed through our agents, who are extended credit in the normal course of business.

Our insurance subsidiaries maintain reinsurance agreements in place with the Mutual Company and with a number of other major unaffiliated authorized reinsurers.

Item 8. Financial Statements and Supplementary Data.

The response to this Item is incorporated by reference to pages 16 through 31 of our Annual Report to Stockholders for the year ended December 31, 2003, which is included as Exhibit (13) to this Form 10-K Report.

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

None.

Item 9A. Controls and Procedures.

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth quarter of 2003 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The response to this Item with respect to our directors is incorporated by reference to pages 4 through 6 and pages 9 through 16 of our proxy statement relating to our annual meeting of stockholders to be held April 15, 2004. The response to this Item with respect to our executive officers is incorporated by reference to Part I of this Form 10-K Report.

We have adopted a Code of Ethics, the full text of which is included as Exhibit 14 to this Form 10-K Report.

Item 11. Executive Compensation.

The response to this Item is incorporated by reference to pages 16 through 21 of our proxy statement relating to our annual meeting of stockholders to be held April 15, 2004, except for the Report of the Compensation Committee, the Performance Graph and the Report of the Audit Committee, which are not incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The response to this Item is incorporated by reference to pages 4 through 6 of our proxy statement relating to our annual meeting of stockholders to be held April 15, 2004.

The following table sets forth information regarding our equity compensation plans:

Equity Compensation Plan Information

Plan category	**Number of securities (class) to be issued upon exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**Number of securities (class) remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))**
	(a)	**(b)**	**(c)**
Equity compensation plans approved by securityholders	1,353,728 (Class A) 125,624 (Class B)	$12.05 (Class A) 8.14 (Class B)	577,975 (Class A) — (Class B)
Equity compensation plans not approved by securityholders	—	—	—
Total	1,479,352	$11.72	577,975

Item 13. Certain Relationships and Related Transactions.

The response to this Item is incorporated by reference to pages 17 and 18 of our proxy statement relating to our annual meeting of stockholders to be held April 15, 2004.

Item 14. Principal Accountant Fees and Services.

The response to this Item is incorporated by reference to pages 22 through 24 of our proxy statement relating to our annual meeting of stockholders to be held April 15, 2004.

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PART IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K.

Financial statements, financial statement schedules and exhibits filed:

Consolidated Financial Statements

Financial Statement Schedules

All other schedules have been omitted since they are not required, not applicable or the information is included in the financial statements or notes thereto.

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* Refers to pages of our 2003 Annual Report to Stockholders. The Consolidated Financial Statements and Notes to Consolidated Financial Statements and Auditor's Report thereon on pages 16 through 31 are incorporated herein by reference. With the exception of the portions of such Annual Report specifically incorporated by reference in this Item and Items 5, 6, 7 and 8 hereof, such Annual Report shall not be deemed filed as part of this Form 10-K Report or otherwise subject to the liabilities of Section 18 of the Exchange Act.

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Exhibits

Exhibit No.	Description of Exhibits	Reference
(3)(i)	Certificate of Incorporation of Registrant, as amended.	(a)
(3)(ii)	Amended and Restated By-laws of Registrant.	(b)
(3)(iii)	Amended and Restated By-laws of Registrant as of March 19, 2004	Filed herewith
	Management Contracts and Compensatory Plans or Arrangements	
(10)(A)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan.	(c)
(10)(B)	Donegal Group Inc. 2001 Equity Incentive Plan for Employees.	(d)
(10)(C)	Donegal Group Inc. 2001 Equity Incentive Plan for Directors.	(d)
(10)(D)	Donegal Group Inc. 2001 Employee Stock Purchase Plan, as amended.	(e)
(10)(E)	Donegal Group Inc. Second Amended and Restated 2001 Agency Stock Purchase Plan.	(f)
(10)(F)	Donegal Mutual Insurance Company 401(k) Plan.	(g)
(10)(G)	Amendment No. 1 effective January 1, 2000 to Donegal Mutual Insurance Company 401(k) Plan.	(g)
(10)(H)	Amendment No. 2 effective January 6, 2000 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
(10)(I)	Amendment No. 3 effective July 23, 2001 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
(10)(J)	Amendment No. 4 effective January 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
(10)(K)	Amendment No. 5 effective December 31, 2001 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
(10)(L)	Amendment No. 6 effective July 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan.	(r)
(10)(M)	Donegal Mutual Insurance Company Executive Restoration Plan.	(h)

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Exhibit No.	Description of Exhibits	Reference
	Other Material Contracts	
(10)(N)	Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company.	(i)
(10)(O)	Services Allocation Agreement dated September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company.	(i)
(10)(P)	Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(i)
(10)(Q)	Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(j)
(10)(R)	Multi-Line Excess of Loss Reinsurance Agreement effective January 1, 2002 among Donegal Mutual Insurance Company, Dorinco Reinsurance Company and Erie Insurance Group.	(r)
(10)(S)	Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(k)
(10)(T)	Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(l)
(10)(U)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia.	(h)
(10)(V)	Amended and Restated Credit Agreement dated as of July 27, 1998 among Donegal Group Inc., the banks and other financial institutions from time to time party thereto and Fleet National Bank, as agent.	(m)
(10)(W)	First Amendment and Waiver to the Amended and Restated Credit Agreement dated as of December 31, 1999.	(g)

Exhibit No.	Description of Exhibits	Reference
(10)(X)	Amendment dated as of April 20, 2000 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(n)
(10)(Y)	Lease Agreement dated as of September 1, 2000 between Donegal Mutual Insurance Company and Province Bank FSB.	(d)
(10)(Z)	Aggregate Excess of Loss Reinsurance Agreement dated as of January 1, 2001 between Donegal Mutual Insurance Company and Atlantic States Insurance Company (as successor-in-interest to Pioneer Insurance Company).	(d)
(10)(AA)	Stock Purchase Agreement dated as of October 28, 2003 between Donegal Group Inc. and Folksamerica Holding Company, Inc.	(p)
(10)(BB)	Credit Agreement dated as of November 25, 2003 between Donegal Group Inc. and Manufacturers and Traders Trust Company	(q)
(13)	2003 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K Report).	Filed herewith
(14)	Code of Ethics	Filed herewith
(20)	Proxy Statement relating to the Annual Meeting of Stockholders to be held on April 15, 2004; provided, however, that the Report of the Compensation Committee, the Performance Graph and the Report of the Audit Committee shall not be deemed filed as part of this Form 10-K Report.	(o)
(21)	Subsidiaries of Registrant.	Filed herewith
(23)	Consent of Independent Auditors.	Filed herewith
(31.1)	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer	Filed herewith

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Exhibit No.	Description of Exhibits	Reference
(31.2)	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Financial Officer	Filed herewith
(32.1)	Section 1350 Certification of Chief Executive Officer	Filed herewith
(32.2)	Section 1350 Certification of Chief Financial Officer	Filed herewith

(a) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-3 Registration Statement No. 333-59828 filed April 30, 2001.

(b) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 2001.

(c) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1998.

(d) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 2000.

(e) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-8 Registration Statement No. 333-62974 filed June 14, 2001.

(f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2/A Registration Statement No. 333-63102 filed December 21, 2001.

(g) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1999.

(h) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1996.

(i) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-1 Registration Statement No. 33-8533 declared effective October 29, 1986.

(j) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1988.

(k) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1992.

(l) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 21, 1995.

(m) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated November 17, 1998.

(n) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated May 31, 2000.

(o) Such exhibit is hereby incorporated by reference to the Registrant's definitive proxy statement filed March 25, 2004.

(p) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form 8-K Report dated October 28, 2003.

(q) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated November 24, 2003.

(r) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 2002.

Reports on Form 8-K:

On October 17, 2003, the Company filed a Current Report on Form 8-K in connection with the Company's release of financial results for the quarter and nine months ended September 30, 2003.

On November 3, 2003, the Company filed a Current Report on Form 8-K in connection with the Company's execution of a stock purchase agreement to acquire all of the outstanding common stock of The Peninsula Insurance Company and Peninsula Indemnity Company; the approval by the policyholders of Le Mars Mutual Insurance Company of Iowa of its conversion; the October 31, 2003 filing by the Company of a Form S-2 registration statement relating to the Company's public offering of 3,450,000 shares of its Class A common stock and the receipt by the Company of a commitment letter from Manufacturers and Traders Trust Company relating to a $35.0 million line of credit, which would be used to repay the Company's outstanding line of credit with Fleet National Bank.

On December 1, 2003, the Company filed a Current Report on Form 8-K in connection with the Company's execution of a Credit Agreement with Manufacturers and Traders Trust Company relating to a four-year $35.0 million unsecured, revolving line of credit and the repayment of the Company's outstanding line of credit with Fleet National Bank and the announcement of the effectiveness of the Company's Form S-2 Registration Statement relating to the public offering of 3,450,000 shares of the Company's Class A common stock and the pricing of the shares being offered.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DONEGAL GROUP INC.

By: /s/ Donald H. Nikolaus
Donald H. Nikolaus, President

Date: March 26, 2004

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Donald H. Nikolaus Donald H. Nikolaus	President and a Director (principal executive officer)	March 26, 2004
/s/ Ralph G. Spontak Ralph G. Spontak	Senior Vice President, Chief Financial Officer and Secretary (principal financial and accounting officer)	March 26, 2004
/s/ Robert S. Bolinger Robert S. Bolinger	Director	March 26, 2004
/s/ Patricia A. Gilmartin Patricia A. Gilmartin	Director	March 26, 2004
/s/ Philip H. Glatfelter Philip H. Glatfelter	Director	March 26, 2004
/s/ John J. Lyons John J. Lyons	Director	March 26, 2004

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Signature	Title	Date
/s/ R. Richard Sherbahn	Director	March 26, 2004
R. Richard Sherbahn		

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DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE I – SUMMARY OF INVESTMENTS
OTHER THAN INVESTMENTS IN RELATED PARTIES
($ in thousands)

December 31, 2003

	Cost	Fair Value	Amount at Which Shown in the Balance Sheet
Fixed Maturities:			
Held to maturity:			
United States government and governmental agencies and authorities	$ 29,131	$ 28,828	$ 29,131
Obligations of states and political subdivisions	45,188	46,244	45,188
Canadian government obligation	499	525	499
All other corporate bonds	25,192	27,278	25,192
Mortgage-backed securities	13,041	13,258	13,041
Total fixed maturities held to maturity	113,051	116,133	113,051
Available for sale:			
United States government and governmental agencies and authorities	69,481	70,507	70,507
Obligations of states and political subdivisions	81,105	84,386	84,386
All other corporate bonds	28,767	30,699	30,699
Mortgage-backed securities	12,744	12,841	12,841
Total fixed maturities available for sale	192,097	198,433	198,433
Total fixed maturities	305,148	314,566	311,484
Equity Securities:			
Preferred stocks:			
Public utilities	102	126	126
Banks	8,617	9,000	9,000
Industrial and miscellaneous	1,450	1,504	1,504
Total preferred stocks	10,169	10,630	10,630
Common stocks:			
Banks and insurance companies	7,098	7,529	7,529
Industrial and miscellaneous	12,377	13,289	13,289
Total common stocks	19,475	20,818	20,818
Total equity securities	29,644	31,448	31,448
Short-term investments	78,344	78,344	78,344
Total investments	$413,136	$424,358	$421,276

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

Condensed Balance Sheets
($ in thousands)
December 31, 2003 and 2002

	2003	2002
ASSETS		
Fixed-maturity investments	$ 1,987	$ —
Investment in subsidiaries (equity method)	183,402	156,684
Short-term investments	47,559	—
Cash	365	604
Property and equipment	1,579	1,640
Other	1,345	99
Total assets	$236,237	$159,027
LIABILITIES AND STOCKHOLDERS' EQUITY		
Cash dividends declared to stockholders	$ 1,379	$ 887
Line of credit	—	19,800
Subordinated debentures	25,774	—
Due to affiliate	—	4,441
Other	435	716
Total liabilities	27,588	25,844
Stockholders' equity	208,649	133,183
Total liabilities and stockholders' equity	$236,237	$159,027

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DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

(Continued)

Condensed Statements of Income and Comprehensive Income
($ in thousands)

Years Ended December 31, 2003, 2002 and 2001

	2003	2002	2001
Statements of Income			
Revenues			
Dividends from subsidiaries	$ 7,000	$10,400	$14,419
Other	1,034	797	824
Total revenues	8,034	11,197	15,243
Expenses			
Operating expenses	1,345	1,057	1,761
Interest	1,320	1,139	2,288
Total expenses	2,665	2,196	4,049
Income before income tax benefit and equity in undistributed net income (loss) of subsidiaries	5,369	9,001	11,194
Income tax benefit	(634)	(435)	(1,067)
Income before equity in undistributed net income (loss) of subsidiaries	6,003	9,436	12,261
Equity in undistributed net income (loss) of subsidiaries	12,291	2,567	(6,443)
Net income	$18,294	$12,003	$ 5,818
Statements of Comprehensive Income			
Net income	$18,294	$12,003	$ 5,818
Other comprehensive income, net of tax			
Unrealized gain (loss) — parent	(42)	15	26
Unrealized gain — subsidiaries	421	2,035	3,035
Other comprehensive income	379	2,050	3,061
Comprehensive income	$18,673	$14,053	$ 8,879

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

(Continued)

Condensed Statements of Cash Flows
($ in thousands)

Years Ended December 31, 2003, 2002 and 2001

	2003	2002	2001
Cash flows from operating activities:			
Net income	$ 18,294	$12,003	$ 5,818
Adjustments:			
Equity in undistributed net loss (income) of subsidiaries	(12,291)	(2,567)	6,443
Other	(4,316)	788	252
Net adjustments	(16,607)	(1,779)	6,695
Net cash provided	1,687	10,224	12,513
Cash flows from investing activities:			
Net purchase of fixed maturities	(1,938)	—	—
Net purchase of short-term investments	(47,559)	—	—
Net purchase of property and equipment	(433)	(480)	(122)
Investment in subsidiaries	(14,274)	—	—
Other	(981)	38	38
Net cash used	(65,185)	(442)	(84)
Cash flows from financing activities:			
Cash dividends paid	(3,868)	(3,509)	(3,394)
Issuance of common stock	61,153	1,728	1,387
Issuance of subordinated debentures	25,774	—	—
Line of credit, net	(19,800)	(7,800)	(12,400)
Net cash provided	63,259	(9,581)	(14,407)
Net change in cash	(239)	201	(1,978)
Cash at beginning of year	604	403	2,381
Cash at end of year	$ 365	$ 604	$ 403

DONEGAL GROUP INC. AND SUBSIDIARIES
SCHEDULE III – SUPPLEMENTARY INSURANCE INFORMATION
($ in thousands)

Years Ended December 31, 2003, 2002 and 2001

Segment	Net Earned Premiums	Net Investment Income	Net Losses And Loss Expenses	Amortization of Deferred Policy Acquisition Costs	Other Underwriting Expenses	Net Premiums Written
Year Ended December 31, 2003						
Personal lines	$125,322	$ —	$ 85,057	$19,639	$18,268	$130,386
Commercial lines	71,471	—	41,186	11,200	10,418	76,595
Investments	—	13,316	—	—	—	—
	$196,793	$13,316	$126,243	$30,839	$28,686	$206,981
Year Ended December 31, 2002						
Personal lines	$119,838	$ —	$ 87,790	$19,005	$16,335	$125,777
Commercial lines	66,003	—	41,478	10,468	8,997	68,727
Investments	—	14,581	—	—	—	—
	$185,841	$14,581	$129,268	$29,473	$25,332	$194,504
Year Ended December 31, 2001						
Personal lines	$104,893	$ —	$ 72,534	$17,002	$16,881	$111,623
Commercial lines	62,877	—	45,644	10,192	10,119	65,405
Investments	—	15,886	—	—	—	—
	$167,770	$15,886	$118,178	$27,194	$27,000	$177,028

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III – SUPPLEMENTARY INSURANCE INFORMATION, CONTINUED
($ in thousands)

	At December 31,			
Segment	Deferred Policy Acquisition Costs	Liability For Losses And Loss Expenses	Unearned Premiums	Other Policy Claims and Benefits Payable
2003				
Personal lines	$ 9,897	$110,700	$ 81,757	$ —
Commercial lines	6,327	107,214	52,271	—
Investments	—	—	—	—
	$16,224	$217,914	$134,028	$ —
2002				
Personal lines	$ 9,423	$106,096	$ 78,273	$ —
Commercial lines	5,144	104,596	42,729	—
Investments	—	—	—	—
	$14,567	$210,692	$121,002	$ —

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE IV – REINSURANCE

	Gross Amount	Ceded To Other Companies	Assumed from Other Companies	Net Amount	Percentage Assumed To Net
Year Ended December 31, 2003					
Property and casualty premiums	$114,154,202	$70,429,560	$153,068,054	$196,792,696	78%
Year Ended December 31, 2002					
Property and casualty premiums	$110,412,498	$58,817,518	$134,246,213	$185,841,193	72%
Year Ended December 31, 2001					
Property and casualty premiums	$105,214,059	$64,220,420	$126,776,215	$167,769,854	76%

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI – SUPPLEMENTARY INSURANCE INFORMATION
CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES

At December 31,	Deferred Policy Acquisition Costs	Liability For Losses And Loss Expenses	Discount, if any, Deducted From Reserves	Unearned Premiums
2003	$16,223,765	$217,914,057	$—	$134,028,035
2002	$14,567,070	$210,691,752	$—	$121,002,447
2001	$13,604,215	$179,839,905	$—	$114,079,264

(continued)

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI - SUPPLEMENTARY INSURANCE INFORMATION
CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES, CONTINUED

Years ended December 31, 2002, 2001 and 2000

	Net Earned Premiums	Investment Income	Losses and Loss Expenses Related to Current Year	Losses and Loss Expenses Related to Prior Years	Amortization of Deferred Policy Acquisition Cost	Net Paid Losses and Loss Expenses	Net Premiums Written
Year Ended December 31, 2003	$196,792,696	$13,315,936	$126,693,421	$ (450,110)	$30,839,000	$118,455,674	$206,980,626
Year Ended December 31, 2002	$185,841,193	$14,581,252	$122,433,653	$6,834,033	$29,473,000	$112,703,368	$194,503,847
Year Ended December 31, 2001	$167,769,854	$15,885,544	$110,142,467	$8,035,082	$27,194,000	$106,342,848	$177,027,654

EXHIBIT 3 (iii)

AMENDED AND RESTATED

BY-LAWS

of

DONEGAL GROUP INC.

Article 1

CORPORATION OFFICE

Section 1.1. Registered Office. The registered office of the Corporation shall be 1100 North Market Street Building, Wilmington, County of New Castle, Delaware, 19801.

Section 1.2. Principal Office. The principal office of the Corporation shall be in Marietta, Pennsylvania.

Section 1.3. Other Offices. The Corporation may also have offices at such other places as the Board of Directors may from time to time designate or the business of the Corporation may from time to time require.

Article 2

STOCKHOLDERS

Section 2.1. Place and Time of Meetings. All meetings of the stockholders shall be held at such time and place as may be fixed from time to time by the Board of Directors and stated in the notice of meeting or in a duly executed waiver of notice thereof. If no such place is fixed by the Board of Directors, meetings of the stockholders shall be held at the principal office of the Corporation.

Section 2.2. Annual Meetings. The annual meeting of the stockholders shall be held on the third Thursday in April in each year, if not a legal holiday, and, if a legal holiday, then on the next full business day, at the Corporation's principal office or at such other place, date and time as shall be designated from time to time by the Board of Directors and stated in the notice of meeting or a duly executed waiver of notice thereof.

At such annual meeting, the stockholders shall elect successors to the directors whose terms shall expire that year to serve for the following three years and until their successors shall have been duly elected and qualified or until their earlier resignation or removal. The stockholders also shall transact such other business as may properly be brought before the meeting and as are consistent with the provisions of these By-laws.

Section 2.3. Stockholder Proposals.

(a) Stockholder Proposals Relating to Nominations for and Election of Directors.

(i) Nominations of candidates for election by stockholders to the Board of Directors shall be made exclusively by the Nominating Committee of the Board of Directors.

(ii) A proposal by a stockholder for the nomination by the Nominating Committee of the Board of Directors of a candidate for election by stockholders as a director at any meeting of stockholders at which directors are to be elected may only be made by notice in writing, delivered in person or by first class United States mail postage prepaid or by reputable overnight delivery service, to the Nominating Committee of the Board of Directors of the Corporation to the attention of the Secretary of the Corporation at the principal office of the Corporation, within the time limits specified herein.

(iii) In the case of an annual meeting of stockholders, any such written proposal of nomination must be received by the Nominating Committee not less than 90 calendar days nor more than 120 calendar days before the first anniversary of the date on which the Corporation first mailed its proxy statement to stockholders for the annual meeting of stockholders in the immediately preceding year; provided, however, that in the case of an annual meeting of stockholders that is called for a date which is not within 30 calendar days before or after the first anniversary date of the annual meeting of stockholders in the immediately preceding year, any such written proposal of nomination must be received by the Board of Directors not less than five business days after the date the Corporation shall have mailed notice to its stockholders that an annual meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that an annual meeting of stockholders will be held.

(iv) In the case of a special meeting of stockholders, any such written proposal of nomination must be received by the Nominating Committee not less than five business days after the earlier of the date that the Corporation shall have mailed notice to its stockholders that a special meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that a special meeting of stockholders will be held.

(v) Such written proposal of nomination shall set forth (A) the name and address of the stockholder who intends to make the nomination (the "Nominating Stockholder"), (B) the name, age, business address and, if known, residence address of each person so proposed, (C) the principal occupation or employment of each person so proposed for the past five years, (D) the number of shares of capital stock of the Corporation beneficially owned within the meaning of Securities and Exchange Commission Rule 13d-3 by each person so proposed and the earliest date of acquisition of any such capital stock, (E) a description of any arrangement or understanding between each person so proposed and the Nominating Stockholder with respect to such person's proposal for nomination and election as a director and actions to be proposed or taken by such person as a director, (F) the written consent of each person so proposed to serve as a director if nominated and elected as a director and (G) such other information regarding each such person as would be required under the proxy solicitation rules of the Securities and Exchange Commission if proxies were to be solicited for the election as a director of each person so proposed.

(vi) If a written proposal of nomination submitted to the Nominating Committee fails, in the reasonable judgment of the Nominating Committee, to contain the information specified in clause (v) hereof or is otherwise deficient, the Chairperson of the Nominating Committee shall, as promptly as is practicable under the circumstances, provide written notice to the Nominating Stockholder of such failure or deficiency in the written proposal of nomination and such Nominating Stockholder shall have five business days from receipt of such notice to submit a revised written proposal of nomination that corrects such failure or deficiency in all material respects.

(vii) Only candidates nominated for election by stockholders as a member of the Board of Directors in accordance with the foregoing provisions of this Section 2.3(a) shall be eligible for election as a member of the Board of Directors at such meeting of stockholders, and any candidate not nominated in accordance with such provisions shall not be considered or acted upon for election as a director at such meeting of stockholders.

(b) Stockholder Proposals Relating to Other Than Nominations for and Elections of Directors.

(i) A stockholder of the Corporation may bring a matter before a meeting of stockholders only if (A) (x) such matter is a proper matter for stockholder action and (y) such stockholder shall have provided notice in writing, delivered in person or by first class United States mail postage prepaid or by reputable overnight delivery service, to the Board of Directors of the Corporation to the attention of the Secretary of the Corporation at the principal office of the Corporation, within the time limits specified herein or (B) the stockholder complies with the provisions of Rule 14a-8 under the Securities Exchange Act of 1934 relating to inclusion of stockholder proposals in the Corporation's proxy statement.

(ii) In the case of an annual meeting of stockholders, any such written notice of presentation of a matter must be received by the Board of Directors not less than 90 calendar days nor more than 120 calendar days before the first anniversary of the date on which the Corporation first mailed its proxy statement to stockholders for the annual meeting of stockholders in the immediately preceding year; provided, however, that in the case of an annual meeting of stockholders that is called for a date which is not within 30 calendar days before or after the first anniversary date of the annual meeting of stockholders in the immediately preceding year, any such written notice of presentation of a matter must be received by the Board of Directors not less than five business days after the date the Corporation shall have mailed notice to its stockholders that an annual meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that an annual meeting of stockholders will be held.

(iii) In the case of a special meeting of stockholders, any such written notice of presentation of a matter must be received by the Board of Directors not less than five business days after the earlier of the date the Corporation shall have mailed notice to its stockholders that a special meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that a special meeting of stockholders will be held.

(iv) Such written notice of presentation of a matter shall set forth information regarding such matter equivalent to the information regarding such matter that would be required under the proxy solicitation rules of the Securities and Exchange Commission if proxies were solicited for stockholder consideration of such matter at a meeting of stockholders.

(v) If a written notice of presentation of a matter submitted to the Board of Directors fails, in the reasonable judgment of the Board of Directors, to contain the information specified in clause (iv) hereof or is otherwise deficient, the Chairperson of the Board of Directors shall, as promptly as is practicable under the circumstances, provide written notice to the stockholder who submitted the written notice of presentation of a matter of such failure or deficiency in the written notice of presentation of a matter and such stockholder shall have five business days from receipt of such notice to submit a revised written notice of presentation of a matter that corrects such failure or deficiency in all material respects.

(vi) Only matters submitted in accordance with the foregoing provisions of this Section 2.3(b) shall be eligible for presentation of such meeting of stockholders, and any matter not submitted to the Board of Directors in accordance with such provisions shall not be considered or acted upon at such meeting of stockholders.

Section 2.4. Special Meetings. Special meetings of stockholders for any purpose or purposes may be called at any time by the President of the Corporation, and shall be called by the Secretary of the Corporation at the request in writing of a majority of the Board of Directors or stockholders owning at least one-fifth of the entire capital stock of the Corporation issued and outstanding and entitled to vote thereat. Any request for a special meeting of stockholders shall be signed by the person or persons making the request and shall state the purpose or purposes of the proposed meeting. Upon receipt of any such request, it shall be the duty of the Secretary of the Corporation to call a special meeting of stockholders to be held at such time, not less than ten nor more than sixty days thereafter, as the Secretary of the Corporation may fix. If the Secretary of the Corporation shall neglect or refuse to issue such call within five days from the receipt of such request, the person or persons making the request may do so. Business transacted at any special meeting of stockholders shall be limited to the purposes stated in the notice of such meeting or a duly executed waiver of notice thereof.

Section 2.5. Notice of Meetings. Written notice of all meetings of stockholders other than adjourned, postponed or continued meetings of stockholders, stating the place, date and hour, and, in the case of special meetings of stockholders, the purpose or purposes thereof, shall be served upon or mailed, postage prepaid, or telegraphed, charges prepaid, not less than ten nor more than sixty days before the date of the meeting to each stockholder entitled to vote thereat at such address as appears on the books of the Corporation. Such notices may be given at the discretion of, or in the name of, the Board of Directors, the President, any Vice

President, the Secretary or any Assistant Secretary. When a meeting is adjourned, postponed or continued it shall not be necessary to give any notice of the adjourned, postponed or continued meeting or of the business to be transacted at the adjourned, postponed or continued meeting, other than by announcement at the meeting at which such adjournment, postponement or continuation is taken.

Section 2.6. Participation in Meetings by Conference Telephone. One or more stockholders may participate in any meeting of the stockholders by means of conference telephone or similar communications equipment which enables all persons participating in the meeting to hear one another, and such person or persons shall be counted for purposes of a quorum.

Section 2.7. Quorum of and Action by Stockholders. The presence, in person, by proxy or by telephonic or similar communications equipment, of stockholders entitled to cast a majority of the votes which all stockholders are entitled to cast on the particular matter shall constitute a quorum for purposes of considering such matter, and, unless otherwise specifically provided by statute, the acts of such stockholders at a duly organized meeting shall be the acts of stockholders with respect to such matter.

If, however, such quorum shall not be present at any meeting of the stockholders, the stockholders entitled to vote thereat present in person, by proxy or by such communications equipment may, except as otherwise provided by statute, adjourn, postpone or continue the meeting from time to time to such time and place as they may determine, without notice other than an announcement at the meeting, until a quorum shall be present in person, by proxy or by such communications equipment.

At any adjourned, postponed or continued meeting at which a quorum had been present, stockholders present in person, by proxy or by such communications equipment at a duly organized and constituted meeting, can continue to do business with respect to any matter properly submitted to the meeting until adjournment, postponement or continuation thereof notwithstanding the withdrawal of enough stockholders to leave less than a quorum for the purposes of considering any particular such matter.

Section 2.8. Voting. Except as may be otherwise provided by statute or by the Certificate of Incorporation, at every meeting of the stockholders, every holder of Class A Common Stock entitled to vote thereat shall have the right to one-tenth of one vote for every share of Class A Common Stock standing in his name on the stock transfer books of the Corporation on the record date fixed for the meeting and every holder of Class B Common Stock entitled to vote thereat shall have the right to one vote for every share of Class B Common Stock standing in his name on the stock transfer books of the Corporation on the record date fixed for the meeting. No share shall be voted at any meeting if any installment is due and unpaid thereon.

When a quorum exists at any meeting, the vote of the holders of Class A Common Stock and Class B Common Stock having a majority of the voting power present at such meeting in person, by proxy or by telephonic or similar communications equipment shall decide any question brought before such meeting, unless the question is one for which, by express provision of statute or of the Certificate of Incorporation or of these By-laws, a different vote is required. Upon demand made by a stockholder at any election of directors before the voting begins, the election shall be by ballot, in which event the vote shall be taken by written ballot, and the judge or judges of election or, if none, the Secretary of the meeting, shall tabulate and certify the results of such vote.

Section 2.9. Voting by Proxy. Every stockholder entitled to vote at a meeting of the stockholders or to express consent or dissent to corporate action in writing without a meeting may authorize another person or persons to act for him by proxy. Every proxy shall be executed in writing by the stockholder or his duly authorized attorney in fact and filed with the Secretary of the Corporation. A proxy, unless coupled with an interest, shall be revocable at will, notwithstanding any other agreement or any provision in the proxy to the contrary, but the revocation of a proxy shall not be effective until written notice thereof has been given to the Secretary of the Corporation. No unrevoked proxy shall be voted or acted upon after three years from the date of its execution, unless a longer time is expressly provided therein. A proxy shall not be revoked by the death or incapacity of the maker, unless, before the vote is counted or the authority is exercised, written notice of such death or incapacity is given to the Secretary of the Corporation.

Section 2.10. Record Date. The Board of Directors may fix a time, not more than sixty nor less than ten days prior to the date of any meeting of the stockholders, or the date fixed for the payment of any dividend or distribution, or the date for the allotment of rights or the date when any change or conversion or exchange of shares will be made or go into effect, as the record date for the determination of the stockholders entitled to notice of, or to vote at, such meeting, or to receive any such allotment of rights or to exercise the rights in respect to any such change or conversion or exchange of shares. In such case, only such stockholders as shall be stockholders of record on the date so fixed shall be entitled to notice of, or to vote at, such meeting or to receive payment of such dividend, or to receive such allotment of rights or to exercise such rights, as the case may be, notwithstanding any transfer of any shares on the books of the Corporation after any record date fixed as aforesaid.

The Board of Directors may close the books of the Corporation against transfers of shares during the whole or any part of such period, and in such case written or printed notice thereof shall be mailed at least ten days before the closing thereof to each stockholder of record at the address appearing on the stock transfer books of the Corporation or supplied by him to the Corporation for the purpose of notice. While the stock transfer books of the Corporation are closed, no transfer of shares shall be made thereon. If no record date is fixed by the Board of Directors for the determination of stockholders who are entitled to receive notice of, or to vote at, a meeting of the stockholders, or to receive payment of any such dividend or distribution, or to receive any such allotment of rights or to exercise the rights in respect to any such change or conversion or exchange of shares, transferees of shares which are transferred on the stock transfer books of the Corporation within the ten days immediately preceding the date of such meeting, dividend, distribution, allotment of rights or exercise of such rights shall not be entitled to notice of, or to vote at, such meeting, or to receive payment of any dividend or distribution, or to receive any such allotment of rights or to exercise the rights in respect to any such change or conversion or exchange of shares.

Section 2.11. Stockholders List. The officer or agent having charge of the stock transfer books for shares of the Corporation shall make, at least ten days before each meeting of the stockholders, a complete alphabetical list of the stockholders entitled to vote at the meeting, with their addresses and the number of shares held by each, which list shall be kept on file either at a place within the city where the meeting is to be held, which place shall be specified in the notice of the meeting or if not so specified, at the place where the meeting is to be held and shall be subject to inspection by any stockholder for any purpose germane to the meeting at any time during usual business hours for a period of at least ten days prior to the meeting. Such list shall be produced at the meeting and shall be kept open for inspection by any stockholder during the entire meeting. The original stock transfer books of the Corporation shall be prima facie evidence as to who are the stockholders entitled to exercise the rights of a stockholder.

Section 2.12. Inspectors of Election. In advance of any meeting of the stockholders, the Board of Directors shall appoint inspectors of election, who need not be stockholders, to act at such meeting or any adjournment, postponement or continuation thereof. If no inspector of election so appointed is able to act at a meeting of stockholders, the chairman of any such meeting shall make such appointment at the meeting. The number of inspectors of election shall be one or three. No person who is a candidate for office shall act as an inspector of election.

The inspectors of election shall do all such acts as may be proper to conduct the election or vote and such other duties as may be prescribed by statute with fairness to all stockholders, and shall make a written report of any matter determined by them and execute a certificate as to any fact found by them. If there are three inspectors of election, the decision, act or certificate of a majority shall be the decision, act or certificate of all.

Section 2.13. Action by Written Consent of the Stockholders. Any action required to be taken at an annual or special meeting of stockholders, or of a class thereof, or any action which may be taken at any annual or special meeting of such stockholders, or of a class thereof, may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing setting forth the action so taken shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted and shall be delivered to the Secretary of the Corporation at its principal place of business as specified in Section 1.2 hereof.

Article 3

DIRECTORS

Section 3.1. Powers.

(a) General Powers. The Board of Directors shall have all the power and authority granted by law to the Board of Directors, including all powers necessary or appropriate to the management of the business and affairs of the Corporation.

(b) Specific Powers. Without limiting the general powers conferred by the last preceding clause and the powers conferred by the Certificate of Incorporation and the By-laws of the Corporation, it is hereby expressly declared that the Board of Directors shall have the following powers:

(i) To appoint any person, firm or corporation to accept and hold in trust for the Corporation any property belonging to the Corporation or in which it is interested, and to authorize any such person, firm or corporation to execute any documents and perform any duties that may be requisite in relation to any such trust;

(ii) To appoint a person or persons to vote shares of another corporation held and owned by the Corporation and, in the absence of any such appointment, the Board of Directors of the Corporation shall have the authority to vote any such shares;

(iii) By resolution adopted by a majority of the whole Board of Directors, to designate one or more committees, each committee to consist of two or more of the directors of the Corporation. To the extent provided in any such resolution, and to the extent permitted by law, a committee so designated shall have and may exercise the authority of the Board of Directors in the management of the business and affairs of the Corporation. The Board of Directors may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. If specifically granted this power by the Board of Directors in its resolution establishing the committee, in the absence or disqualification of any member and all designated alternates of such committee or committees or if the whole Board of Directors has failed to designate alternate members, the member or members thereof present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another director to act at the meeting in the place of any such absent or disqualified member;

(iv) To fix the place, time and purpose of meetings of the stockholders; and

(v) To fix the compensation of directors and officers for their services.

Section 3.2. Number and Terms of Directors. The number of directors which shall constitute the whole Board of Directors shall be not less than seven nor more than twelve, who shall be natural persons of full age and need not be residents of Delaware or stockholders of the Corporation. Within the limits above specified, the number of directors shall be as determined from time to time by resolution of the Board of Directors. Except as hereinafter provided in the case of vacancies, each director shall be elected by the affirmative vote of a plurality of the votes cast by the holders of Class A Common Stock and of Class B

Common Stock for a term of three years and until his successor has been elected, subject to removal as provided by statute.

Section 3.3. Classes. The Board of Directors shall be divided into three classes: Class A, Class B and Class C. At each annual meeting of the stockholders, the successors to the directors of the class whose term shall expire in that year shall be elected for a term of three years so that the term of office of one class of directors shall expire in each year. The number of directors in each class shall be as nearly equal as possible so that, except for temporary vacancies, the number in any class shall not exceed the number in any other class by more than one.

Section 3.4. Powers and Duties of the Chairman of the Board of Directors. The Board of Directors shall appoint one of their number as the Chairman of the Board who shall preside at all meetings of the Board of Directors and who shall have such other powers and duties as may be assigned to him from time to time by the Board of Directors.

Section 3.5. Powers and Duties of the Vice Chairman of the Board of Directors. The Board of Directors may, in its discretion, appoint one of its number as a Vice Chairman of the Board of Directors. In the absence of the Chairman of the Board of Directors, the Vice Chairman of the Board of Directors shall preside at all meetings of the Board of Directors. In addition, the Vice Chairman of the Board of Directors shall have such other powers and duties as may be assigned to him from time to time by the Board of Directors.

Section 3.6. Vacancies. Vacancies on the Board of Directors, including vacancies resulting from an increase in the number of directors, shall be filled by a majority of the remaining members of the Board of Directors, though less than a quorum, or by the sole remaining director, as the case may be, irrespective of whether holders of any class or series of stock or other voting securities of the Corporation are entitled to elect one or more directors to fill such vacancies or newly created directorships at the next annual meeting of the stockholders. Each person so elected shall be a director until his successor is elected by the stockholders at the annual meeting of the stockholders at which the class of directors to which he was elected is up for election or at any special meeting of the stockholders prior thereto duly called for that purpose.

Section 3.7. Organization Meetings. The organization meeting of each newly elected Board of Directors shall be held immediately following each annual meeting of the stockholders at which directors were elected without the necessity of notice to such directors to constitute a legally convened meeting or at such time and place as may be fixed by a notice, or a waiver of notice, or a consent signed by all of such directors. At such meeting, the Board of Directors shall elect officers of the Corporation and may also choose an Executive Committee consisting of two members of the Board of Directors in addition to the President.

Section 3.8. Regular Meetings. The Board of Directors shall have the power to fix by resolution the place, date and hour of regular meetings of the Board of Directors.

Section 3.9. Special Meetings. Special meetings of the Board of Directors may be called by the President of the Corporation on one day's notice to each director, either personally or by mail, telephone or telegram. Special meetings of the Board of Directors shall be called by the President or the Secretary of the Corporation in like manner and on like notice upon the written request of any five directors.

Section 3.10. Notices of Meetings. All meetings of the Board of Directors may be held at such times and places as may be specified in the notice of meeting or in a duly executed waiver of notice thereof. Notice of regular meetings of the Board of Directors shall be given to each director at least three days before each meeting either personally or by mail, telegram or telephone. One or more directors may participate in any meeting of the Board of Directors, or of any committee thereof, by means of a conference telephone or similar communications equipment which enables all persons participating in the meeting to hear one another, and such participation in a meeting shall constitute presence in person at the meeting.

Section 3.11. Quorum. At all meetings of the Board of Directors, the presence, in person or by telephonic or similar communications equipment, of a majority of the members of the Board of Directors shall constitute a quorum for the transaction of business, and the acts of a majority of the directors present at a duly convened meeting at which a quorum is present shall be the acts of the Board of Directors, except as may be otherwise specifically provided by statute, by the Certificate of Incorporation of the Corporation or by these By-laws. If a quorum shall not be present, in person or by telephonic or similar communications equipment, at any meeting of the Board of Directors, the directors present may adjourn, postpone or continue the meeting from time to time, without notice other than announcement at the meeting, until a quorum shall be so present.

Section 3.12. Action by Unanimous Written Consent. Any action required or permitted to be taken at any meeting of the Board of Directors or of any committee thereof may be taken without a meeting if all members of the Board of Directors or a committee thereof, as the case may be, consent thereto in writing, and such consent is filed with the minutes of proceedings of the Board of Directors, or committee.

Section 3.13. Compensation. Directors, as such, may receive a stated salary for their services, or a fixed sum and expenses for attendance at regular or special meetings of the Board of Directors, or any committee thereof, or any combination of the foregoing as may be determined from time to time by resolution of the Board of Directors, and nothing contained herein shall be construed to preclude any director from serving the Corporation in any other capacity and receiving compensation therefor.

Section 3.14. The Coordinating Committee. The Coordinating Committee shall consist of two members of the Corporation's Board of Directors, each of whom is not a member of the Board of Directors or an officer of Donegal Mutual Insurance Company, and two members of the Board of Directors of Donegal Mutual Insurance Company, each of whom is not a member of the Board of Directors or an officer of the Corporation. The Coordinating Committee shall review and either approve or disapprove all contracts and other matters involving actual or potential conflicts of interest between the Corporation and Donegal Mutual Insurance Company. Whenever any new contract between the Corporation and Donegal Mutual Insurance Company is proposed or any change is proposed in any existing contract between the Corporation and Donegal Mutual Insurance Company or any other matter arises that presents an actual or potential conflict of interest between the Corporation and Donegal Mutual Insurance Company, such new contract, change in an existing contract or other matter shall (i) first be submitted for approval to the respective Boards of Directors of the Corporation and of Donegal Mutual Insurance Company, (ii) only following approval by the respective Boards of Directors of the Corporation and Donegal Mutual Insurance Company shall the new contract, change in an existing contract or other matter be submitted to the Coordinating Committee for its consideration thereof and (iii) the proposed new contract, change in an existing contract or other matter shall be consummated only if (A) both of the Corporation's members of the Coordinating Committee conclude that such new contract, change in an existing contract or other matter is fair and equitable to the Corporation and its stockholders and (B) both of Donegal Mutual Insurance Company's members of the Coordinating Committee conclude that such new contract, change in an existing contract or other matter is fair and equitable to Donegal Mutual Insurance Company and its policyholders. For purposes of this Section 3.14, the term "the Corporation" shall mean Donegal Group Inc. and its direct and indirect wholly owned subsidiaries and the term "Donegal Mutual Insurance Company" shall mean Donegal Mutual Insurance Company and its direct and indirect wholly owned subsidiaries.

Section 3.15. Executive Committee. There shall be an Executive Committee that shall have and exercise all power and authority of the Board of Directors between meetings of the Board of Directors to the extent consistent with Delaware law. The Executive Committee shall consist of not fewer than three members of the Board of Directors, one of whom shall be the Chief Executive Officer of the Corporation and who shall be Chairman of the Executive Committee, unless another member shall be designated by resolution of the Board of Directors. The members of the Executive Committee shall be designated from time to time by resolution of the Board of Directors. Not less than one-third of the committee must be directors who are not officers or employees of the Corporation or of any entity controlling, controlled by or under common control with the Corporation and who are not beneficial owners of a controlling interest in the voting securities of the Corporation. The Executive Committee shall meet at any time and place designated upon not fewer than six hours oral or written notice given by or on behalf of the Chairman of the Executive Committee. The

Executive Committee shall report promptly to the entire Board of Directors the substance of any action taken by the Executive Committee.

Section 3.16. Audit Committee. The Board of Directors shall appoint annually an Audit Committee that shall consist of not fewer than three directors who satisfy applicable independence requirements, are not officers or employees of the Corporation or of any entity controlling, controlled by or under common control with the Corporation and who are not beneficial owners of a controlling interest in the voting securities of the Corporation. The Audit Committee shall operate in accordance with its written charter adopted by the Board of Directors on March 19, 2004 and shall have responsibility for the selection of the Corporation's independent public accountants, reviewing the scope and results of the audit and reviewing the adequacy of the Corporation's accounting, financial, internal and operating controls.

Section 3.17. Nominating Committee. The Board of Directors shall appoint annually a Nominating Committee which shall consist of not fewer than two directors who satisfy applicable independence requirements, are not officers or employees of the Corporation or of any entity controlling, controlled by, or under common control with the Corporation and who are not beneficial owners of a controlling interest in the voting securities of the Corporation. The Nominating Committee shall operate in accordance with its written charter as adopted by the Board of Directors on March 19, 2004 and shall have responsibility for identification of individuals believed to be qualified to become members of the Board of Directors and to recommend to the Board of Directors nominees to stand for election as directors, identification of members of the Board of Directors qualified to serve on the various committees of the Board of Directors, evaluation of the procedures and processes by which the committees of the Board of Directors conduct a self-evaluation of their performance and provision to the Board of Directors of an annual performance evaluation of the Nominating Committee. The Chief Executive Officer of the Company shall be an ex-officio member of the Nominating Committee.

Section 3.18. Compensation Committee. The Board of Directors shall appoint annually a Compensation Committee that shall consist of not fewer than two directors who satisfy applicable independence requirements, are not officers or employees of the Corporation or of any entity controlling, controlled by, or under common control with the Corporation and who are not beneficial owners of a controlling interest in the voting securities of the Corporation. The Compensation Committee shall be responsible for the annual review of the compensation of the Corporation's executive officers, the provision of annual compensation recommendations to the Board of Directors for all of the Corporation's officers, the determination of employees who participate in the Corporation's employee stock option plans and the provision of recommendations to the Board of Directors as to individual stock option grants and the general oversight of the Corporation's employee benefit plans.

Article 4

OFFICERS

Section 4.1. Election and Office. The officers of the Corporation shall be elected annually by the Board of Directors at its organization meeting and shall consist of a President, a Secretary and a Treasurer. The Board of Directors may also elect one or more Vice Presidents and such other officers and appoint such agents as it shall deem necessary. Each officer of the Corporation shall hold office for such term, have such authority and perform such duties as set forth in these By-laws or as may from time to time be prescribed by the Board of Directors in consultation with the President. Any two or more offices may be held by the same person.

Section 4.2. Salaries. The salaries of all officers of the Corporation shall be fixed by the Board of Directors.

Section 4.3. Removal and Vacancies. The Board of Directors may remove any officer or agent elected or appointed at any time and within the period, if any, for which such person was elected or employed whenever in the judgment of the Board of Directors it is in the best interests of the Corporation, and all persons shall be elected and employed subject to the provisions hereof. If the office of any officer becomes vacant for any reason, the vacancy shall be filled by the Board of Directors.

Section 4.4. Powers and Duties of the President. Unless otherwise determined by the Board of Directors, the President shall have the usual duties of a chief executive officer with general supervision over and direction of the affairs of the Corporation. In the exercise of these duties and subject to the limitations of the laws of the State of Delaware or any other applicable law, these By-laws and the actions of the Board of Directors, he may appoint, suspend and discharge employees, agents and assistant officers, may fix the compensation of all officers and assistant officers, shall preside at all meetings of the stockholders at which he shall be present, and, unless there is a Chairman of the Board of Directors, shall preside at all meetings of the Board of Directors and shall be a member of all committees. He shall also do and perform such other duties as from time to time may be assigned to him by the Board of Directors.

Unless otherwise determined by the Board of Directors, the President shall have full power and authority on behalf of the Corporation to attend and to act and to vote at any meeting of the stockholders of any corporation in which the Corporation may hold stock, and, at any such meeting, shall possess and may exercise any and all the rights and powers incident to the ownership of such stock and which, as the owner thereof, the Corporation might have possessed and exercised.

Section 4.5. Powers and Duties of Vice Presidents. Each Vice President shall have such duties as may be assigned to him from time to time by the Board of Directors, the Executive Committee or the President. In the event of a temporary absence of the President on vacation or business, the President may designate a Vice President or Vice Presidents who will perform the duties of the President in such absence. In the event of a prolonged absence of the President due to illness or disability or for any other reason, the Board of Directors shall designate a Vice President or Vice Presidents who will perform the duties of the President during such absence.

Section 4.6. Powers and Duties of the Secretary. The Secretary of the Corporation shall attend all meetings of the Board of Directors and of the stockholders and shall keep accurate records thereof in one or more minute books kept for that purpose, shall give, or cause to be given, the required notice of all meetings of the stockholders and of the Board of Directors, shall keep in safe custody the corporate seal of the Corporation and affix the same to any instrument requiring it, and when so affixed, it shall be attested by his signature or by the signature of the Treasurer or any Assistant Secretary or Assistant Treasurer of the Corporation. The Secretary also shall keep, or cause to be kept, the stock certificate books, stock transfer books and stock ledgers of the Corporation, in which shall be recorded all stock issues, transfers, the dates of same, the names and addresses of all stockholders and the number of shares held by each, shall, when necessary, prepare new certificates upon the transfer of shares and the surrender of the old certificates, shall cancel such surrendered certificates and shall perform such other duties as may be assigned to him by the President.

Section 4.7. Powers and Duties of the Treasurer. The Treasurer of the Corporation shall have the custody of the Corporation's funds and securities, shall keep full and accurate accounts of receipts and disbursements in books belonging to the Corporation, shall deposit all moneys and other valuable effects in the name and to the credit of the Corporation in such depositories as shall be designated by the President, shall disburse the funds of the Corporation as may be ordered by the President or the Board of Directors, taking proper vouchers for such disbursements, shall render to the President and the Board of Directors, at the regular meetings of the Board of Directors or whenever they may require it, an account of all his transactions as Treasurer and of the financial condition of the Corporation and shall have the right to affix the seal of the Corporation to any instrument requiring it, and to attest to the same by his signature and, if so required by the Board of Directors, he shall give bond in such sum and with such surety as the Board of Directors may from time to time direct.

Section 4.8. Designation of a Chief Financial Officer. The Board of Directors shall have the power to designate from among the President, any Vice President or the Treasurer of the Corporation a Chief Financial Officer who shall be deemed the principal financial and accounting officer. In the event that the Treasurer is not designated by the Board of Directors as the Chief Financial Officer, the Treasurer shall report to the Chief Financial Officer from time to time concerning all duties which the Treasurer is obligated to perform and the Chief Financial Officer shall, subject to the reasonable direction of the President or the Board of Directors, at his election, assume such of the duties of the Treasurer as are provided in Section 4.7 hereof as he shall deem appropriate.

Article 5

INDEMNIFICATION

Section 5.1. Indemnification. The Corporation shall indemnify any director or officer of the Corporation and any director or officer of its subsidiaries against expenses, including legal fees, judgments, fines and amounts paid in settlement, actually and reasonably incurred by him to the fullest extent now or hereafter permitted by law in connection with any threatened, pending or completed action, suit or proceeding, whether derivative or nonderivative, and whether civil, criminal, administrative or investigative, brought or threatened to be brought against him by reason of his performance or status as a director or officer of the Corporation, any of its subsidiaries or any other entity in which he was serving at the request of the Corporation or in any other capacity on behalf of the Corporation, its parent or any of its subsidiaries if such officer or director acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the Corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.

Notwithstanding the foregoing, in the case of any threatened, pending or completed action or suit by or in the right of the Corporation, no indemnification shall be made in respect of any claim, issue or matter as to which such officer or director shall have been adjudged to be liable to the Corporation unless and only to the extent the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the court shall deem proper.

The Board of Directors by resolution adopted in each specific instance may similarly indemnify any person other than a director or officer of the Corporation for liabilities incurred by him in connection with services rendered by him for or at the request of the Corporation or any of its subsidiaries.

The provisions of this Section 5.1 shall be applicable to all actions, suits or proceedings commenced after its adoption, whether such arise out of acts or omissions which occurred prior or subsequent to such adoption and shall continue as to a person who has ceased to be a director or officer or to render services for or at the request of the Corporation and shall inure to the benefit of the heirs, executors and administrators of such a person. The rights of indemnification provided for herein shall not be deemed the exclusive rights to which any such director, officer or other person may be entitled.

Section 5.2. Authorization and Determination of Indemnification. Any indemnification under this Article 5, unless ordered by a court, shall be made by the Corporation only as authorized in the specific case upon a determination that indemnification of the director, officer or other person is proper in the circumstances because he has met the applicable standard of conduct as specified in Section 5.1 of this Article 5. A person shall be deemed to have met such applicable standard of conduct if his action is based on the records or books of account of the Corporation or another enterprise, or on information supplied to him by the officers of the Corporation or another enterprise in the course of their duties, or on the advice of legal counsel for the Corporation or another enterprise or on information or records given or reports made to the Corporation or another enterprise by an independent certified public accountant or by an appraiser or other expert selected with reasonable care by the Corporation or another enterprise.

Such determination shall be made (i) by the Board of Directors by a majority vote of a quorum consisting of directors who were not parties to such action, suit or proceeding, or (ii) if such a quorum is not obtainable, or, even if obtainable, a majority vote of a quorum of disinterested directors so directs, by independent legal counsel in a written opinion or (iii) by the stockholders. To the extent, however, that a director, officer or other person has been successful on the merits or otherwise in defense of any action, suit or proceeding described above, or in defense of any claim, issue or matter therein, he shall be indemnified against expenses, including attorneys' fees, actually and reasonably incurred by him in connection therewith, without the necessity of authorization in the specific case.

The provisions of this Section 5.2 shall not be deemed to be exclusive or to limit in any way the circumstances in which a person may be deemed to have met such applicable standard of conduct.

Section 5.3. Advances. Expenses incurred in defending or investigating a threatened or pending action, suit or proceeding shall be paid by the Corporation in advance of the final disposition of such action, suit or proceeding as authorized by the Board of Directors upon receipt of an undertaking by or on behalf of the director, officer or other person to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the Corporation as authorized in this Article 5.

Section 5.4. Scope and Alteration of Indemnification Provisions. The indemnification and advancement of expenses provided by, or granted pursuant to, the other sections of this Article 5 shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any By-law, agreement, contract, vote of the stockholders or disinterested directors or pursuant to the direction, howsoever embodied, of any court of competent jurisdiction or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office, it being the policy of the Corporation that indemnification of, and advancement of expenses to, the persons specified in Section 5.1 of this Article 5 shall be made to the fullest extent permitted by law.

To this end, the provisions of this Article 5 shall be deemed to have been amended for the benefit of such persons effective immediately upon any modification of the General Corporation Law of the State of Delaware which expands or enlarges the power or obligation of corporations organized under such law to indemnify, or advance expenses to, such persons. The provisions of this Article 5 shall not be deemed to preclude the indemnification of, or advancement of expenses to, any person who is not specified in this Section 5.4 or Section 5.1 of this Article 5 but whom the Corporation has the power or obligation to indemnify, or to advance expenses for, under the provisions of the General Corporation Law of the State of Delaware or otherwise.

Section 5.5. Insurance. The Corporation may purchase and maintain insurance on behalf of any person who is or was a director, officer or employee of the Corporation, or is or was serving at the request of the Corporation as a director, officer or employee of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the Corporation would have the power or the obligation to indemnify him against such liability under the provisions of this Article 5.

Section 5.6. Definitions. For purposes of this Article 5, references to the "Corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors, officers, and employees or agents, so that any person who is or was a director, officer or employee of such constituent corporation, or is or was serving at the request of such constituent corporation as a director, officer or employee of another corporation, partnership, joint venture, trust or other enterprise, shall stand in the same position under the provisions of this Article 5 with respect to the resulting or surviving corporation as he would have with respect to such constituent corporation if its separate existence had continued.

The term "another enterprise" as used in this Article 5 shall mean any other corporation or any partnership, joint venture, trust or other entity of which such person is or was serving at the request of the Corporation as a director, officer, employee or agent and shall include employee benefit plans.

Article 6

CAPITAL STOCK

Section 6.1. Stock Certificates. The certificates for shares of the Corporation's capital stock shall be numbered and registered in a share register as they are issued, shall bear the name of the registered holder, the number and class of shares represented thereby and the par value of each share or a statement that such shares are without par value, as the case may be, shall be signed by the President or any Vice President of the Corporation and the Secretary, any Assistant Secretary or the Treasurer of the Corporation or any other person properly authorized by the Board of Directors and shall bear the seal of the Corporation, which seal may be a facsimile engraved or printed. Where the certificate is signed by a transfer agent or a registrar, the signature of any corporate officer on such certificate may be a facsimile engraved or printed. In case any officer who has signed, or whose facsimile signature has been placed upon, any share certificate shall have ceased to be such officer because of death, resignation or otherwise, before the certificate is issued, it may be issued by the Corporation with the same effect as if the officer had not ceased to be such at the date of its issue.

Section 6.2. Transfer of Shares. Upon surrender to the Corporation of a share certificate duly endorsed by the person named in the certificate or by an attorney duly appointed in writing and accompanied where necessary by proper evidence of succession, assignment or authority to transfer, a new certificate shall be issued to the person entitled thereto and the old certificate cancelled and the transfer recorded upon the stock transfer books and share register of the Corporation.

Section 6.3. Lost Certificates. Should any stockholder of the Corporation allege the loss, theft or destruction of one or more certificates for shares of the Corporation and request the issuance by the Corporation of a substitute certificate therefor, the Board of Directors may direct that a new certificate of the same tenor and for the same number of shares be issued to such person upon such person's making of an affidavit in form satisfactory to the Board of Directors setting forth the facts in connection therewith, provided that prior to the receipt of such request the Corporation shall not have either registered a transfer of such certificate or received notice that such certificate has been acquired by a bona fide purchaser. When authorizing such issuance of a new certificate, the Board of Directors may, in its discretion and as a condition precedent to the issuance of such certificate, require the owner of such lost, stolen or destroyed certificate, or his heirs or legal representatives, as the case may be, to advertise the same in such manner as the Board of Directors shall require and/or to give the

Corporation a bond in such form and for such sum and with such surety or sureties, with fixed or open penalty, as shall be satisfactory to the Board of Directors, as indemnity for any liability or expense which it may incur by reason of the original certificate remaining outstanding.

Section 6.4. Dividends. The Board of Directors may, from time to time, at any duly convened regular or special meeting or by unanimous consent, declare and pay dividends upon the outstanding shares of capital stock of the Corporation in cash, property or shares of the Corporation.

Before payment of any dividend, there may be set aside out of any funds of the Corporation available for dividends such sum or sums as the Board of Directors from time to time, in its absolute discretion, shall deem proper as a reserve fund to meet contingencies, or for equalizing dividends, or for repairing or maintaining any property of the Corporation or for such other purposes as the Board of Directors shall believe to be in the best interests of the Corporation, and the Board of Directors may reduce or abolish any such reserve in the manner in which it was created.

Article 7

FINANCIAL REPORT TO STOCKHOLDERS

The President of the Corporation and the Board of Directors shall present at each annual meeting of the stockholders a full and complete statement of the business and affairs of the Corporation for the preceding year. Such statement shall be prepared and presented in whatever manner the Board of Directors shall deem advisable and need not be verified by a certified public accountant or sent to the stockholders of the Corporation.

Article 8

CHECKS AND NOTES

All checks or demands for money and notes of the Corporation shall be signed by such officer or officers or such other person or persons as the Board of Directors or the President may from time to time designate.

Article 9

FISCAL YEAR

The fiscal year of the Corporation shall be as determined from time to time by resolution of the Board of Directors.

Article 10

SEAL

The seal of the Corporation shall have inscribed thereon the name of the Corporation, the year of its organization and the words "Corporate Seal, Delaware." Said seal may be used by causing it or a facsimile thereof to be impressed or affixed or in any manner reproduced.

Article 11

NOTICES; COMPUTING TIME PERIODS

Section 11.1. Method and Contents of Notice. Whenever, under the provisions of statute or of the Certificate of Incorporation or of these By-laws, written notice is required to be given to any person, it may be given to such person either personally or by sending a copy thereof through the mail, postage prepaid, or by telegram, charges prepaid, to his address appearing on the books of the Corporation or supplied by him to the Corporation for the purpose of notice. If the notice is sent by mail or telegraph, it shall be deemed to have been given to the person entitled thereto when deposited in the United States mail or with a telegraph office for transmission to such person. Such notice shall specify the place, day and hour of the meeting, if any, and, in the case of a special meeting of the stockholders, the general nature of the business to be transacted.

Section 11.2. Waiver of Notice. Any written notice required to be given to any person may be waived in a writing signed by the person entitled to such notice whether before or after the time stated therein. Attendance of any person entitled to notice, whether in person or by proxy, at any meeting shall constitute a waiver of notice of such meeting, except where any person attends a meeting for the express purpose of objecting to the transaction of any business because the meeting was not lawfully called or convened. Where written notice is required for any meeting, the waiver thereof must specify the purpose only if it is for a special meeting of the stockholders.

Section 11.3. Computing Time Periods. In computing the number of days for purposes of these By-laws, all days shall be counted, including Saturdays, Sundays or holidays; provided, however, that if the final day of any time period falls on a Saturday, Sunday or holiday, then the final day shall be deemed to be the next day which is not a Saturday, Sunday or holiday. In computing the number of days for the purpose of giving notice of any meeting, the date upon which the notice is given shall be counted but the day set for the meeting shall not be counted.

Article 12

AMENDMENTS

These By-laws may be altered, amended or repealed by a majority vote of the stockholders entitled to vote thereon at any annual or special meeting duly convened after notice to the stockholders of that purpose or by a majority vote of the members of the Board of Directors at any regular or special meeting of the Board of Directors duly convened after notice to the Board of Directors of that purpose, subject always to the power of the stockholders to change such action of the Board of Directors.

Article 13

INTERPRETATION OF BY-LAWS

All words, terms and provisions of these By-laws shall be interpreted and defined by and in accordance with the General Corporation Law of the State of Delaware, as amended, and as amended from time to time hereafter.

Last Amended March 19, 2004

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EXHIBIT 13

SELECTED CONSOLIDATED FINANCIAL DATA

Year Ended December 31,	2003	2002	2001	2000	1999
INCOME STATEMENT DATA:					
Premiums earned	$ 196,792,696	$ 185,841,193	$ 167,769,854	$ 151,646,199	$ 145,517,457
Investment income, net	13,315,936	14,581,252	15,885,544	16,394,747	13,590,695
Realized investment gains (losses)	1,368,031	144,190	(880,254)	170,852	(38,702)
Total revenues	214,992,328	203,803,561	185,163,623	170,581,587	161,739,336
Income before income taxes	25,436,375	16,494,584	7,091,729	11,743,028	3,844,641
Income taxes (benefit)	7,142,399	4,491,862	1,273,598	2,906,248	(2,950,556)
Net income	18,293,976	12,002,722	5,818,131	8,836,780	6,795,197
Basic earnings per common share	1.91	1.32	0.65	1.01	0.82
Diluted earnings per common share	1.85	1.31	0.64	1.01	0.82
Cash dividends per share of common stock (a)	N/A	N/A	N/A	0.36	0.36
Cash dividends per share of Class A common stock (a)	.43	0.40	0.40	N/A	N/A
Cash dividends per share of Class B common stock (a)	.39	0.36	0.36	N/A	N/A
BALANCE SHEET DATA AT YEAR END:					
Total investments	$ 421,276,467	$ 332,299,094	$ 300,633,355	$ 289,344,642	$ 268,010,854
Total assets	602,036,042	501,218,164	456,632,372	426,008,780	389,688,804
Debt obligations	25,774,000	19,800,000	27,600,000	40,000,000	37,000,000
Stockholders' equity	208,649,232	133,182,850	120,928,349	114,129,591	103,792,334
Stockholders' equity per share	16.29	14.52	13.44	12.88	12.28

In January 2001, the Company acquired all of the outstanding stock of Pioneer-New York from the Mutual Company, which previously owned 100% of Pioneer-New York. The acquisition has been accounted for as a reorganization of entities under common control, similar to a pooling of interests, as both Pioneer-New York and the Company are under the common management and control of the Mutual Company. As such, all financial data prior to January 1, 2001 has been restated to include Pioneer-New York as a consolidated subsidiary.

(a) In April 2001, the Company reclassified its common stock as Class B common stock and created a new class of common stock with one-tenth of a vote per share designated as Class A common stock. Also in April 2001, the Company effected a one-for-three reverse split of the Company's Class B common stock and issued a dividend of two shares of Class A common stock for each share of Class B common stock. The effect of the reverse split and the stock dividend taken together is that the Company had the same total number of shares outstanding after the reverse split and the stock dividend as it did before the reverse split and the stock dividend. Therefore, there was no change in the historical earnings per share of the Class A common stock and the Class B common stock.

FINANCIAL INFORMATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

GENERAL

We were organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") on August 26, 1986. We operate predominantly as an underwriter of personal and commercial lines of property and casualty insurance through our subsidiaries. Our personal lines products consist primarily of homeowners and private passenger automobile policies. Our commercial lines products consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. Our two insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States") and Southern Insurance Company of Virginia ("Southern") write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in the Mid-Atlantic and Southern states. In January 2004, we acquired Le Mars Insurance Company ("Le Mars") and the Peninsula Insurance Group ("Peninsula"), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company. We also own 47.5% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a thrift holding company. The Mutual Company owns the remaining 52.5% of the outstanding stock of DFSC.

At December 31, 2003, the Mutual Company held approximately 42% of our outstanding Class A common stock and approximately 62% of our outstanding Class B common stock. We refer to the Mutual Company and our insurance subsidiaries as the Donegal Insurance Group.

TRANSACTIONS WITH AFFILIATES

Atlantic States, our largest subsidiary, and the Mutual Company have a pooling agreement under which both companies are allocated a given percentage of their combined underwriting results, excluding certain reinsurance assumed by the Mutual Company from our insurance subsidiaries. Atlantic States has a 70% share of the results of the pool, and the Mutual Company has a 30% share of the results of the pool. The pooling agreement is intended to produce more uniform and stable underwriting results from year to year for each pool participant than they would experience individually and to spread the risk of loss among the participants based on each participant's relative amount of surplus and relative access to capital. Each participant in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposures of a size commensurate with its own capital and surplus.

In addition to the pooling agreement and third-party reinsurance, our insurance subsidiaries have various reinsurance arrangements with the Mutual Company. These agreements include:

- catastrophe reinsurance agreements with each of our insurance subsidiaries,

- an excess of loss reinsurance agreement with Southern

- a workers' compensation reallocation agreement with Southern and

- a 100% retrocessional agreement with Southern.

The excess of loss and catastrophe reinsurance agreements are intended to lessen the effects of a single large loss, or an accumulation of losses arising from one event, to levels that are appropriate given each subsidiary's size, underwriting profile and surplus position.

The Mutual Company and Southern have an agreement in place to reallocate the loss results of workers' compensation business written by Southern as part of commercial accounts primarily written by the Mutual Company or Atlantic States. This agreement provides for the workers' compensation loss ratio of Southern to be no worse than the average workers' compensation loss ratio for the Donegal Insurance Group.

Southern has a 100% retrocessional agreement between the Mutual Company that is intended to provide Southern with the same A.M. Best rating, currently A (Excellent), as the Mutual Company, which Southern might not be able to achieve without this agreement in place. The retrocessional agreement does not otherwise provide for pooling or reinsurance with or by the Mutual Company and does not transfer insurance risk.

The Mutual Company provides facilities, personnel and other services to us, and the related expenses are allocated between Atlantic States and the Mutual Company in relation to their relative participation in the pooling agreement. Southern reimburses the Mutual Company for its personnel costs and bears its proportionate share of information services costs based on its percentage of total written premiums of the Donegal Insurance Group.

Subsequent to the receipt of applicable board approvals, all agreements and all changes to existing agreements between our subsidiaries and the Mutual Company are subject to approval by a coordinating committee that is comprised of two of our board members who do not serve on the Mutual Company board and two board members of the Mutual Company who do not serve on our board. In order to approve an agreement or a change in an agreement, our members on the coordinating committee must conclude that the agreement or change is fair to us and our stockholders, and the Mutual Company's members on the coordinating committee must conclude that the agreement or change is fair to the Mutual Company and its policyholders.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our financial statements are combined with those of our insurance subsidiaries and are presented on a consolidated basis in accordance with United States generally accepted accounting principles.

We make estimates and assumptions that can have a significant effect on amounts and disclosures we report in our financial statements. The most significant estimates relate to our reserves for property and casualty insurance unpaid losses and loss expenses, valuation of investments, policy acquisition costs and guaranty fund liability accruals. While we believe our estimates are appropriate, the ultimate amounts may differ from the estimates provided. The methods for making these estimates are reviewed on a regular basis, and any adjustment considered necessary is reflected in our current results of operations.

LIABILITY FOR LOSSES AND LOSS EXPENSES

With respect to reserves for property and casualty unpaid losses and loss expenses, significant components of our estimates include a variety of factors such as medical inflation trends, regulatory and judicial rulings, legal settlements, property replacements, repair cost trends and losses for assumed reinsurance. In recent years, certain of these component costs, such as medical inflation trends and legal settlements, have experienced significant volatility and resulted in incurred amounts higher than our original estimates, and we have factored these changes in trends into our loss estimates. However, due to the nature of these liabilities, actual results could ultimately vary significantly from the amounts recorded.

Loss reserves are set at full-expected cost. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results.

We occasionally receive new information on files that had previously been closed. For example, one of our policyholders may incur losses that were not known at the time of the original claim settlement. We are also exposed to larger than historical settlements due to changes in law, precedent or underlying inflation on pending and unreported claims. When we experience adverse development of losses from prior accident years, our current year underwriting results are negatively impacted. To the extent our prior year reserve deficiencies are indicative of deteriorating underlying loss trends and are material, we seek to increase the pricing of affected lines of business to the extent permitted by state departments of insurance. We also review trends in loss development in order to determine if adjustments, such as reserve strengthening, are appropriate. Because of our participation in the pool, we are exposed to adverse loss development on the business of the Mutual Company included in the pool.

INVESTMENTS

We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in the value of our investments. When we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its estimated net realizable value, and the amount of the write-down is reflected as a realized loss in our statement of income. We individually monitor all investments for other than temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in an unrealized loss position for more than six months, we assume there has been an other than temporary decline in value. With respect to debt securities, we assume there has been an other than temporary decline in value if it is probable that contractual payments will not be received. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including: the fair value of the investment being significantly below its cost, the deteriorating financial condition of the issuer of a security, the occurrence of industry, company and geographic events that have negatively impacted the value of a security or rating agency downgrades.

Our investments in available-for-sale fixed maturity and equity securities are presented at estimated fair value, which generally represents quoted market prices.

During 2003, we sold certain bonds that had been classified as held to maturity due to a series of rating agency downgrades. These bonds had an amortized cost of $1.8 million, and the sale resulted in a realized gain of $165,564. During 2002, we sold certain bonds that had been classified as held to maturity due to significant deterioration in the issuer's credit worthiness. These bonds had an amortized cost of $488,901, and the sale resulted in a realized loss of $73,901. There were no other sales or transfers from the held to maturity portfolio in 2003 and 2002.

POLICY ACQUISITION COSTS

Policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and are directly related to the production of business, are deferred and amortized over the period in which the premiums are earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, losses and loss expenses and certain other costs expected to be incurred as the premium is earned.

GUARANTY FUND LIABILITY ACCRUALS

We make estimates of our insurance subsidiaries' liabilities for guaranty fund and other assessments because of insurance company insolvencies from states in which the subsidiaries are licensed. Generally, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies. We generally record our liability for such assessments as premiums upon which those assessments are based are written. As a result of several large insolvencies in recent years, we are currently being assessed at the maximum level permitted by Pennsylvania law for several of our lines of business, and we expect we will continue to be assessed by Pennsylvania at the maximum level for these business lines for a number of years.

MANAGEMENT EVALUATION OF OPERATING RESULTS

We evaluate the performance of the commercial lines and personal lines segments primarily based upon underwriting results as determined under statutory accounting practices (SAP), which our management uses to measure performance for our total business. We use the following financial data to monitor and evaluate our operating results:

(amount in thousands)	Year Ended December 31, 2003	2002	2001
Net Premiums Written:			
Personal lines:			
Automobile	$ 86,644	$ 84,643	$ 74,396
Homeowners	36,989	34,637	31,431
Other	6,753	6,497	5,796
Total personal lines	130,386	125,777	111,623
Commercial lines:			
Automobile	18,655	17,451	16,527
Workers' compensation	25,627	23,845	22,979
Commercial multiperil	30,199	25,536	24,174
Other	2,114	1,895	1,725
Total commercial lines	76,595	68,727	65,405
Total net premiums written	$ 206,981	$ 194,504	$ 177,028
Components of GAAP Combined Ratio:			
Loss ratio	64.2%	69.6%	70.5%
Expense ratio	30.2	29.5	32.3
Dividend ratio	0.6	0.5	1.0
GAAP combined ratio	95.0%	99.6%	103.8%
Revenues:			
Premiums earned:			
Personal lines	$ 125,322	$ 119,838	$ 104,893
Commercial lines	71,471	66,003	62,877
Total premiums earned	196,793	185,841	167,770
Net investment income	13,316	14,581	15,886
Realized investment gains (losses)	1,368	144	(880)
Other	3,515	3,238	2,388
Total revenues	$ 214,992	$ 203,804	$ 185,164
Components of Net Income:			
Underwriting income (loss):			
Personal lines	$ 2,004	$ (5,056)	$ (5,090)
Commercial lines	7,173	6,326	(3,037)
SAP underwriting income (loss)	9,177	1,270	(8,127)
GAAP adjustments	692	(558)	1,833
GAAP underwriting income (loss)	9,869	712	(6,294)
Net investment income	13,316	14,581	15,886
Realized investment gains (losses)	1,368	144	(880)
Other	883	1,058	(1,620)
Income before income taxes	25,436	16,495	7,092
Income taxes	7,142	4,492	1,274
Net income	$ 18,294	$ 12,003	$ 5,818

RESULTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2003 AND 2002
NET PREMIUMS WRITTEN

Our 2003 net premiums written increased by 6.4% to $207.0 million, compared to $194.5 million for 2002. Commercial lines net premiums written increased $7.9 million, or 11.4%, for 2003 compared to 2002. Personal lines net premiums written increased $4.6 million, or 3.7%, for 2003 compared to 2002. We have benefited during these periods, and expect to continue to benefit, from premium increases by our insurance subsidiaries that have resulted from pricing actions approved by regulators. These increases related primarily to private passenger automobile, commercial multiple peril, workers' compensation and homeowners lines of business realized in most of the states in which we operate. In addition to pricing increases, we have also benefited from organic growth in most of the states in which we operate.

NET PREMIUMS EARNED

Our net premiums earned increased to $196.8 million for 2003, an increase of $11.0 million, or 5.9%, over 2002. Our net earned premiums during 2003 have grown due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of our policies, which are generally one-year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the same period one year earlier.

INVESTMENT INCOME

For 2003, our net investment income decreased 8.7% to $13.3 million, compared to $14.6 million for 2002. An increase in our average invested assets from $316.5 million in 2002 to $376.8 million in 2003 was more than offset by a decrease in our annualized average return on investments from 4.6% in 2002 to 3.5% in 2003, and accounted for the decrease in investment income in 2003 compared to 2002. The decrease in our annualized average return during both years compared to the prior years reflects a declining interest rate environment.

NET REALIZED INVESTMENT GAINS/LOSSES

Our net realized investment gains in 2003 were $1.4 million, compared to $144,190 in 2002. Our net realized investment gains in 2003 were net of impairment charges of $237,724, compared to impairment charges of $378,672 recognized in 2002. Our impairment charges for both years were the result of declines in the market value of common stocks that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

LOSSES AND LOSS EXPENSES

Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in 2003 was 64.2%, compared to 69.6% in 2002. Our commercial lines loss ratio decreased to 57.7% in 2003, compared to 61.5% in 2002. Our commercial automobile and workers' compensation loss ratios showed improvement in 2003, with the commercial automobile loss ratio decreasing to 51.9% in 2003, compared to 61.6% in 2002, and the workers' compensation loss ratio decreasing to 60.5% in 2003, compared to 73.1% in 2002. The personal lines loss ratio improved from 73.3% in 2002 to 67.8% in 2003, primarily as a result of improvement in the personal automobile loss ratio in 2003 compared to 2002. Improvements in our 2003 loss ratios reflect the benefits of premium pricing increases and more favorable prior accident year loss development compared to the same period in 2002.

UNDERWRITING EXPENSES

Our expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, in 2003 was 30.2%, compared to 29.5% in 2002. Improvements from expense control efforts were offset by higher underwriting-based incentive costs incurred in 2003 compared to 2002.

COMBINED RATIO

Our combined ratio was 95.0% and 99.6% in 2003 and 2002, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned. The improvement in our combined ratio was attributable to the decrease in the loss ratio between years.

INTEREST EXPENSE

Our interest expense in 2003 was $1.3 million, compared to $1.1 million in 2002, reflecting an increase in interest expense related to the issuance of $25.8 million of subordinated debentures in 2003, offset by decreases in the average interest rates and average borrowings under our line of credit in 2003 compared to 2002.

INCOME TAXES

Our income tax expense was $7.1 million in 2003, compared to $4.5 million in 2002, representing effective tax rates of 28.1% and 27.2%, respectively. The change between effective tax rates is due to tax-exempt interest representing a slightly smaller proportion of net income before taxes in 2003 compared to 2002.

NET INCOME AND EARNINGS PER SHARE

Our net income in 2003 was $18.3 million, an increase of 52.4% over the $12.0 million reported in 2002. Our diluted earnings per share were $1.85 in 2003 compared to $1.31 in 2002.

BOOK VALUE PER SHARE AND RETURN ON EQUITY

Our stockholders' equity increased by $75.5 million in 2003, primarily as a result of the issuance of 3.45 million shares of Class A common stock in December 2003, which resulted in $59.0 million in net proceeds to us. Book value per share increased by 12.2% to $16.29 at December 31, 2003, compared to $14.52 a year earlier. Our return on average equity was 12.2% in 2003, compared to 9.4% in 2002.

YEARS ENDED DECEMBER 31, 2002 AND 2001

NET PREMIUMS WRITTEN

Our net premiums written in 2002 increased by 9.9% to $194.5 million, compared to $177.0 million in 2001. Personal lines net premiums written increased $14.2 million, or 12.7%, for 2002 compared to 2001. Commercial lines net premiums written increased $3.3 million, or 5.1%, for 2002 compared to 2001. We implemented rate increases in various lines of business throughout the year to improve profitability.

NET PREMIUMS EARNED

Our net premiums earned for 2002 increased to $185.8 million, an increase of $18.1 million, or 10.8%, over 2001. Earned premiums grew due to the increase in written premiums during 2002.

INVESTMENT INCOME

Our investment income for 2002 decreased 8.2% to $14.6 million, compared to $15.9 million for 2001. An increase in average invested assets from $295.0 million in 2001 to $316.5 million in 2002 was more than offset by a decrease in the annualized average return on investments from 5.3% in 2001 to 4.6% in 2002, and accounted for the decrease in investment income in 2002 compared to 2001. The decrease in our annualized average return reflects a declining interest rate environment during both periods.

NET REALIZED INVESTMENT GAINS/LOSSES

Our net realized investment gains in 2002 were $144,190, compared to net realized investment losses of $880,254 in 2001. Our net realized investment gains in 2002 were net of impairment charges of $378,672, compared to impairment charges of $1.5 million in 2001. The impairment charges in both years were the result of declines in the market value of common stocks that were determined to be other than temporary.

LOSSES AND LOSS EXPENSES

Our loss ratio in 2002 was 69.6%, compared to 70.5% in 2001. Our commercial lines loss ratio decreased significantly to 61.5% in 2002, compared to 72.7% in 2001, with the commercial automobile loss ratio showing the greatest improvement as it decreased from 85.0% in 2001 to 61.6% in 2002. Our personal lines loss ratio increased from 69.2% in 2001 to 73.3% in 2002. Net losses and loss expenses for 2002 and 2001 included adverse development of prior accident year losses amounting to $6.8 million and $8.0 million, respectively. In 2002, the adverse loss development was primarily in private passenger automobile liability and physical damage and, to a lesser extent, in commercial lines of business, such as workers' compensation, commercial automobile liability and commercial multiperil. The 2002 loss development resulted principally from accident year 2001 claims and the normal claims review process and not from any changes in key assumptions or changes in reserving philosophy. The 2001 adverse loss development was primarily in commercial lines of business. The 2001 development included $4.2 million of reserve strengthening primarily in the workers' compensation and commercial auto lines of business.

UNDERWRITING EXPENSES

Our expense ratio in 2002 was 29.5%, compared to 32.3% in 2001. Improvement in our expense ratio was primarily a result of the cost reduction program implemented in late 2001. The expense ratio in 2001 included a guaranty fund assessment of approximately $543,000 resulting from the insolvency of Reliance Insurance Company. This assessment also contributed to the change in the expense ratio between years.

COMBINED RATIO

Our combined ratio was 99.6% in 2002, compared to 103.8% in 2001. The improvement in our combined ratio was primarily attributable to the decrease in the expense ratio between periods.

INTEREST EXPENSE

Interest expense in 2002 was $1.1 million, compared to $2.2 million in 2001, reflecting decreases in average borrowings under our line of credit and decreases in the average interest rates for the respective periods.

INCOME TAXES

Income tax expense was $4.5 million in 2002, an effective tax rate of 27.2%, compared to $1.3 million, or an effective tax rate of 18.0%, in 2001. Tax-exempt interest represented a smaller proportion of net income before taxes in 2002 compared to 2001 and accounted for the difference between the effective rates.

NET INCOME AND EARNINGS PER SHARE

Our net income in 2002 was $12.0 million, an increase of 106.3% over the $5.8 million reported in 2001. Diluted earnings per share were $1.31 for 2002 compared to $0.64 for the previous year.

FINANCIAL CONDITION

LIQUIDITY AND CAPITAL RESOURCES

Liquidity is a measure of an entity's ability to secure enough cash to meet its contractual obligations and operating needs as they arise. Our major sources of funds from operations are the net cash flow generated from our insurance subsidiaries' underwriting results, investment income and maturing investments.

We generate sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. We maintain a high degree of liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. Net cash flows provided by operating activities in 2003, 2002 and 2001, were $30.8 million, $34.1 million and $22.0 million, respectively.

On May 15, 2003, we received $15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At December 31, 2003, the interest rate on the debentures was 5.28%.

On October 29, 2003, we received $10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2003, the interest rate on the debentures was 5.01%.

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year $35.0 million unsecured, revolving line of credit. As of December 31, 2003, we may borrow up to $35.0 million at interest rates equal to the bank's current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our subsidiaries. As of December 31, 2003, there were no borrowings outstanding, and we complied with all requirements of the agreement.

On December 1, 2003, we completed an underwritten public offering of 3.45 million shares of our Class A common stock, resulting in net proceeds of $59.0 million to us.

At December 31, 2002, pursuant to a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank, we had unsecured borrowings of $19.8 million. Such borrowings were made in connection with the various acquisitions and capital contributions to our subsidiaries. The borrowings under this line of credit were repaid during 2003, and this credit agreement was terminated on December 2, 2003.

Dividends declared to stockholders totaled $4.4 million, $3.5 million and $3.5 million in 2003, 2002 and 2001, respectively. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Atlantic States and Southern are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States and Southern are subject to risk-based capital (RBC) requirements. At December 31, 2003, Atlantic States' and Southern's capital were each substantially above the RBC requirements. In 2004, amounts available for distribution as dividends to us without prior approval of their domiciliary insurance regulatory authorities are $13.3 million from Atlantic States and $4.1 million from Southern.

We had two pending acquisitions at December 31, 2003, both of which were consummated in January 2004. As of January 1, 2004, we acquired all of the outstanding capital stock of Le Mars, the successor to Le Mars Mutual Insurance Company of Iowa following its conversion to a stock insurance company pursuant to a plan of conversion. We acquired the capital stock of Le Mars for approximately $12.6 million in cash, including payment of $4.4 million to the Mutual Company for a surplus note and accrued interest that the Mutual Company had infused into Le Mars.

Le Mars operates as a multiple line carrier in Iowa, Nebraska, Oklahoma and South Dakota. Personal lines coverages represent a majority of premiums written, with the balance coming from farmowners and mercantile and service businesses. Le Mars' largest lines of business are private passenger automobile liability and physical damage; other principal lines include homeowners and commercial multiperil.

On January 6, 2004, we acquired all of the outstanding common stock of Peninsula from Folksamerica Holding Company, Inc. pursuant to a Stock Purchase Agreement. The cash purchase price of approximately $23.3 million was equal to 107.5% of the consolidated GAAP stockholders' equity of Peninsula as of the date of closing of the acquisition.

The Peninsula companies are each Maryland-domiciled insurance companies headquartered in Salisbury, Maryland, which write primarily private passenger automobile coverages, and also write homeowners, commercial multiperil, workers' compensation and commercial automobile coverages. Peninsula's principal operating area is Maryland, Delaware and Virginia.

INVESTMENTS

At December 31, 2003 and 2002, our investment portfolio of investment-grade bonds, common stock, preferred stock, short-term investments and cash totaled $427.2 million, and $333.4 million, respectively, representing 71.0% and 66.5%, respectively, of our total assets.

At December 31, 2003 and 2002, the carrying value of our fixed maturity investments represented 73.9% and 84.7% of our total invested assets, respectively.

Our fixed maturity investments consisted of high-quality marketable bonds, all of which were rated at investment-grade levels, at December 31, 2003 and 2002.

At December 31, 2003, the net unrealized gain on fixed maturities, net of deferred taxes, amounted to $4.1 million, compared to $4.7 million at December 31, 2002.

At December 31, 2003, the net unrealized gain on our equity securities held, net of deferred taxes, amounted to $1.2 million, compared to $163,500 at December 31, 2002.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to the impact of interest rate changes, changes in market values of investments and to credit risk.

In the normal course of business, we employ established policies and procedures to manage our exposure to changes in interest rates, fluctuations in the value of the fair market value of our debt and equity securities and credit risk. We seek to mitigate these risks by various actions described below.

INTEREST RATE RISK

Our exposure to market risk for a change in interest rates is concentrated in the investment portfolio. We monitor this exposure through periodic reviews of asset and liability positions. Estimates of cash flows and the impact of interest rate fluctuations relating to the investment portfolio are monitored regularly. Generally, we do not hedge our exposure to interest rate risk because we have the capacity to, and do, hold fixed maturity investments to maturity.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 2003 are as follows:

(amounts in thousands)	Principal cash flows	Weighted-average interest rate
Fixed maturities and short-term bonds:		
2004	$ 92,194	1.74%
2005	13,337	5.86%
2006	32,989	4.81%
2007	31,236	4.63%
2008	40,075	4.01%
Thereafter	169,209	4.85%
Total	$ 379,040	
Market Value	$ 392,910	
Debt:		
2033	$ 25,774	5.17%
Total	$ 25,774	
Fair value	$ 25,774	

Actual cash flows from investments may differ from those stated as a result of calls and prepayments.

EQUITY PRICE RISK

Our portfolio of marketable equity securities, which is carried on the consolidated balance sheets at estimated fair value, has exposure to price risk, the risk of potential loss in estimated fair value resulting from an adverse change in prices. Our objective is to earn competitive relative returns by investing in a diverse portfolio of high-quality, liquid securities.

CREDIT RISK

Our objective is to earn competitive returns by investing in a diversified portfolio of securities. Our portfolios of fixed maturity securities and, to a lesser extent, short-term investments are subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing up front underwriting analysis and through regular reviews by the Company's investment staff. The fixed maturity investments are also maintained between minimum and maximum percentages of invested assets.

We provide property and liability insurance coverages through independent insurance agencies located throughout our operating area. The majority of this business is billed directly to the insured, although a portion of our commercial business is billed through our agents who are extended credit in the normal course of business.

Our insurance subsidiaries maintain reinsurance agreements in place with the Mutual Company and with a number of other major unaffiliated authorized reinsurers.

IMPACT OF INFLATION

Property and casualty insurance premium rates are established before the amount of losses and loss settlement expenses, or the extent to which inflation may impact such expenses, are known. Consequently, we attempt, in establishing rates, to anticipate the potential impact of inflation.

Donegal Group Inc.

CONSOLIDATED BALANCE SHEETS

December 31,	2003	2002
ASSETS		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value $116,133,002 and $89,785,318)	$ 113,050,784	$ 86,701,556
Available for sale, at fair value (amortized cost $192,097,372 and $187,495,949)	198,433,337	194,731,660
Equity securities, available for sale, at fair value (cost $29,644,333 and $21,587,317)	31,448,221	21,836,460
Short-term investments, at cost, which approximates fair value	78,344,125	29,029,418
Total investments	421,276,467	332,299,094
Cash	5,908,521	1,124,604
Accrued investment income	3,752,075	3,815,449
Premiums receivable	29,016,940	26,286,482
Reinsurance receivable	81,009,106	83,207,272
Deferred policy acquisition costs	16,223,765	14,567,070
Deferred tax asset, net	7,032,409	6,955,707
Prepaid reinsurance premiums	30,691,654	27,853,996
Property and equipment, net	4,151,671	4,430,394
Accounts receivable -- securities	1,524,384	146,507
Other	1,449,050	531,589
Total assets	$ 602,036,042	$ 501,218,164
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Losses and loss expenses	$ 217,914,057	$ 210,691,752
Unearned premiums	134,028,035	121,002,447
Accrued expenses	7,769,879	6,583,825
Reinsurance balances payable	1,355,796	1,100,443
Federal income taxes payable	315,808	357,547
Cash dividend declared to stockholders	1,378,993	887,315
Borrowings under line of credit	--	19,800,000
Subordinated debentures	25,774,000	--
Accounts payable -- securities	2,438,784	2,121,619
Due to affiliate	904,452	4,080,415
Other	1,507,006	1,409,951
Total liabilities	393,386,810	368,035,314
Stockholders' Equity		
Preferred stock, $1.00 par value, authorized 2,000,000 shares; none issued	--	--
Class A common stock, $.01 par value, authorized 30,000,000 shares, issued 9,880,506 and 6,269,093 shares and outstanding 9,798,982 and 6,187,569 shares	98,805	62,691
Class B common stock, $.01 par value, authorized 10,000,000 shares, issued 3,051,811 and 3,024,742 shares and outstanding 3,011,049 and 2,983,980 shares	30,518	30,247
Additional paid-in capital	122,744,905	60,651,751
Accumulated other comprehensive income	5,290,923	4,911,953
Retained earnings	81,375,829	68,417,956
Treasury stock, at cost	(891,748)	(891,748)
Total stockholders' equity	208,649,232	133,182,850
Total liabilities and stockholders' equity	$ 602,036,042	$ 501,218,164

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

Year Ended December 31,	2003	2002	2001
STATEMENTS OF INCOME			
Revenues			
Net premiums earned (includes affiliated reinsurance of $94,173,934, $86,195,962 and $71,989,136)	$ 196,792,696	$ 185,841,193	$ 167,769,854
Investment income, net of investment expenses	13,315,936	14,581,252	15,885,544
Installment payment fees	2,464,604	2,447,229	1,587,396
Lease income	845,211	789,697	801,083
Net realized investment gains (losses)	1,368,031	144,190	(880,254)
Other income	205,850	--	--
Total revenues	214,992,328	203,803,561	185,163,623
Expenses			
Net losses and loss expenses (includes affiliated reinsurance of $53,659,974, $54,684,955 and $50,283,481)	126,243,311	129,267,686	118,177,549
Amortization of deferred policy acquisition costs	30,839,000	29,473,000	27,194,000
Other underwriting expenses	28,686,365	25,331,777	27,000,485
Policy dividends	1,154,773	1,056,790	1,691,759
Interest	1,287,197	1,119,204	2,247,465
Other	1,345,307	1,060,520	1,760,636
Total expenses	189,555,953	187,308,977	178,071,894
Income before income tax expense	25,436,375	16,494,584	7,091,729
Income tax expense	7,142,399	4,491,862	1,273,598
Net income	$ 18,293,976	$ 12,002,722	$ 5,818,131
Net income per common share			
Basic	$ 1.91	$ 1.32	$ .65
Diluted	$ 1.85	$ 1.31	$ .64
STATEMENTS OF COMPREHENSIVE INCOME			
Net income	$ 18,293,976	$ 12,002,722	$ 5,818,131
Other comprehensive income, net of tax			
Unrealized gains on securities:			
Unrealized holding gain arising during the period, net of income tax expense of $754,840,$1,148,224 and $1,277,504	1,268,190	2,144,813	2,479,860
Reclassification adjustment for (gains)losses included in net income, net of income tax expense (benefit) of $478,811, $49,565 and $(299,286)	(889,220)	(94,625)	580,968
Other comprehensive income	378,970	2,050,188	3,060,828
Comprehensive income	$ 18,672,946	$ 14,052,910	$ 8,878,959

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock					
	Prior Shares	Class A Shares	Class B Shares	Prior Amount	Class A Amount	Class B Amount
Balance, January 1, 2001	8,980,977	--	--	$ 8,980,977	$ --	$ --
Issuance of common stock	61,830	60,144	3,758	61,830	601	38
Recapitalization	(9,042,807)	6,027,975	3,013,987	(9,042,807)	60,280	30,140
Net income						
Cash dividends						
Exercise of stock options		9,095	4,220		91	42
Grant of stock options						
Other comprehensive income						
Balance, December 31, 2001	--	6,097,214	3,021,965	$ --	$ 60,972	$30,220
Issuance of common stock		166,972			1,670	
Net income						
Cash dividends						
Exercise of stock options		4,907	2,777		49	27
Grant of stock options						
Other comprehensive income						
Balance, December 31, 2002	--	6,269,093	3,024,742	$ --	$ 62,691	$30,247
Issuance of common stock		3,547,000			35,470	
Net income						
Cash dividends						
Exercise of stock options		64,413	27,069		644	271
Grant of stock options						
Other comprehensive income						
Balance, December 31, 2003	--	9,880,506	3,051,811	$ --	$ 98,805	$30,518

	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, January 1, 2001	$ 46,969,840	$ (199,063)	$ 59,269,593	$(891,756)	$ 114,129,591
Issuance of common stock	1,200,202				1,262,671
Recapitalization	8,949,361			8	(3,018)
Net income			5,818,131		5,818,131
Cash dividends			(3,466,947)		(3,466,947)
Exercise of stock options	126,960				127,093
Grant of stock options	1,641,352		(1,641,352)		--
Other comprehensive income		3,060,828			3,060,828
Balance, December 31, 2001	$ 58,887,715	$ 2,861,765	$ 59,979,425	$(891,748)	$ 120,928,349
Issuance of common stock	1,641,547				1,643,217
Net income			12,002,722		12,002,722
Cash dividends			(3,526,157)		(3,526,157)
Exercise of stock options	84,455				84,531
Grant of stock options	38,034		(38,034)		--
Other comprehensive income		2,050,188			2,050,188
Balance, December 31, 2002	$ 60,651,751	$ 4,911,953	$ 68,417,956	$(891,748)	$ 133,182,850
Issuance of common stock	60,193,670				60,229,140
Net income			18,293,976		18,293,976
Cash dividends			(4,360,026)		(4,360,026)
Exercise of stock options	923,407				924,322
Grant of stock options	976,077		(976,077)		--
Other comprehensive income		378,970			378,970
Balance, December 31, 2003	$122,744,905	$ 5,290,923	$ 81,375,829	$(891,748)	$ 208,649,232

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended December 31,	2003	2002	2001
Cash Flows from Operating Activities:			
Net income	$ 18,293,976	$ 12,002,722	$ 5,818,131
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,532,664	1,236,592	1,127,510
Realized investment (gains) losses	(1,368,031)	(144,190)	880,254
Changes in Assets and Liabilities:			
Losses and loss expenses	7,222,305	30,851,847	23,363,781
Unearned premiums	13,025,588	6,923,183	14,138,883
Accrued expenses	1,186,054	(602,282)	1,308,632
Premiums receivable	(2,730,458)	(2,142,951)	(2,385,029)
Deferred policy acquisition costs	(1,656,695)	(962,855)	(1,320,001)
Deferred income taxes	(352,731)	(579,654)	(1,360,633)
Reinsurance receivable	2,198,166	(15,354,098)	(13,309,290)
Accrued investment income	63,374	(50,373)	237,388
Amounts due to/from affiliate	(3,175,963)	65,341	(513,922)
Reinsurance balances payable	255,353	261,287	(795,819)
Prepaid reinsurance premiums	(2,837,658)	1,739,471	(4,881,083)
Current income taxes	(41,739)	650,165	(32,656)
Other, net	(820,406)	181,965	(271,364)
Net adjustments	12,499,823	22,073,448	16,186,651
Net cash provided by operating activities	30,793,799	34,076,170	22,004,782
Cash Flows from Investing Activities:			
Purchase of fixed maturities			
Held to maturity	(51,747,067)	(35,867,577)	(45,201,470)
Available for sale	104,935,346)	(75,783,783)	(71,700,918)
Purchase of equity securities	(20,779,807)	(18,325,041)	(12,440,994)
Sale of fixed maturities			
Held to maturity	1,971,000	415,000	--
Available for sale	16,575,179	461,965	16,250,109
Maturity of fixed maturities			
Held to maturity	22,256,933	34,967,828	51,313,296
Available for sale	84,393,268	58,798,825	50,781,533
Sale of equity securities	12,683,028	13,394,123	7,089,532
Net purchase of property and equipment	(371,477)	(552,005)	(161,269)
Net purchases of short-term investments	(49,314,707)	(4,955,218)	(4,634,695)
Net cash used in investing activities	(89,268,996)	(27,445,883)	(8,704,876)
Cash Flows from Financing Activities:			
Issuance of common stock	61,153,462	1,727,748	1,386,746
Issuance of subordinated debentures	25,774,000	--	--
Payments on line of credit	(19,800,000)	(7,800,000)	(12,400,000)
Cash dividends paid	(3,868,348)	(3,508,719)	(3,394,352)
Net cash provided by (used in) financing activities	63,259,114	(9,580,971)	(14,407,606)
Net increase (decrease) in cash	4,783,917	(2,950,684)	(1,107,700)
Cash at beginning of year	1,124,604	4,075,288	5,182,988
Cash at end of year	$ 5,908,521	$ 1,124,604	$ 4,075,288

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS

1--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION AND BUSINESS

We were organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") and operate predominantly as an underwriter of property and casualty insurance through our subsidiaries. Our two property and casualty insurance subsidiaries during 2003, Atlantic States Insurance Company ("Atlantic States") and Southern Insurance Company of Virginia ("Southern") write personal and commercial lines property and casualty coverages exclusively through a network of independent insurance agents in the Mid-Atlantic and Southern states. In January 2004, we also acquired Le Mars Insurance Company ("Le Mars") and the Peninsula Insurance Group ("Peninsula"), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company. We have three operating segments: the investment function, the personal lines function and the commercial lines function. Our personal lines products consist primarily of homeowners and private passenger automobile policies. Our commercial lines products consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. At December 31, 2003, the Mutual Company held approximately 42% of our outstanding Class A common stock and approximately 62% of our outstanding Class B common stock.

Atlantic States participates in a pooling agreement with the Mutual Company. Under the pooling agreement, the insurance business of the two companies is pooled, and Atlantic States assumes 70% of the pooled business. Prior to January 1, 2002, Southern ceded 50% of its business to the Mutual Company. We also own 47.5% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a thrift holding company. The remaining 52.5% of the outstanding stock of DFSC is owned by the Mutual Company.

Pioneer Insurance Company of Ohio ("Pioneer-Ohio"), Delaware Atlantic Insurance Company ("Delaware") and Pioneer Insurance Company of New York ("Pioneer-New York"), previously wholly owned subsidiaries, were merged into Atlantic States on May 1, 2002, August 1, 2001 and September 30, 2001, respectively. Southern Heritage Insurance Company, previously a wholly owned subsidiary, was merged into Southern on May 1, 2002. The mergers were accounted for as statutory mergers and had no financial impact on the consolidated entity.

On December 1, 2003, we completed an underwritten public offering of 3,450,000 shares of our Class A common stock, resulting in net proceeds of $59.0 million to us.

In June 2002, the Mutual Company consummated an affiliation with Le Mars. As part of the affiliation, the Mutual Company entered into a management agreement with and made a $4.0 million surplus note investment in Le Mars. During 2003, Le Mars' board of directors adopted a plan of conversion to convert to a stock insurance company. Following policyholder and regulatory approval of the plan of conversion, we acquired Le Mars as of January 1, 2004 for approximately $12.6 million in cash, including payment of the surplus note and accrued interest to the Mutual Company.

On January 6, 2004, we purchased Peninsula for a price in cash equal to 107.5% of Peninsula's GAAP stockholders' equity as of the closing of the acquisition, or approximately $23.3 million.

BASIS OF CONSOLIDATION

The consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, include our accounts and those of our wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The term "we," "us," "our," or the "Company" as used herein refer to the consolidated entity.

USE OF ESTIMATES

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ significantly from those estimates.

We make estimates and assumptions that can have a significant effect on amounts and disclosures we report in our financial statements. The most significant estimates relate to our reserves for property and casualty insurance unpaid losses and loss expenses, valuation of investments, policy acquisition costs and guaranty fund liability accruals. While we believe our estimates are appropriate, the ultimate amounts may differ from the estimates provided. The methods for making these estimates are continually reviewed, and any adjustment considered necessary is reflected in our current results of operations.

INVESTMENTS

We classify our debt and equity securities into the following categories:

Held to Maturity--Debt securities that we have the positive intent and ability to hold to maturity; reported at amortized cost.

Available for Sale--Debt and equity securities not classified as held to maturity; reported at fair value, with unrealized gains and losses excluded from income and reported as a separate component of stockholders' equity (net of tax effects).

Short-term investments are carried at amortized cost, which approximates fair value.

If there is a decline in fair value below amortized cost that is other than temporary, the cost basis for such investments in the held to maturity and available for sale categories is reduced to fair value. Such decline in cost basis is recognized as a realized loss and charged to income.

Premiums and discounts on debt securities are amortized over the life of the security as an adjustment to yield using the effective interest method. Realized investment gains and losses are computed using the specific identification method.

Premiums and discounts for mortgage-backed debt securities are amortized using anticipated prepayments.

FAIR VALUES OF FINANCIAL INSTRUMENTS

We have used the following methods and assumptions in estimating our fair value disclosures:

Investments--Fair values for fixed maturity securities are based on quoted market prices, when available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments or values obtained from independent pricing services through a bank trustee. The fair values for equity securities are based on quoted market prices.

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

Premium and Reinsurance Receivables and Payables--The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Borrowings Under Line of Credit and Subordinated Debentures--The carrying amounts reported in the balance sheet for the line of credit and subordinated debentures approximate fair value due to their variable rate nature.

REVENUE RECOGNITION

Insurance premiums are recognized as income over the terms of the policies. Unearned premiums are calculated on a daily pro-rata basis.

POLICY ACQUISITION COSTS

Policy acquisition costs, consisting primarily of commissions, premium taxes and certain other variable underwriting costs, are deferred and amortized over the period in which the premiums are earned. Anticipated losses and loss expenses, expenses for maintenance of policies in force and anticipated investment income are considered in the determination of the recoverability of deferred acquisition costs.

PROPERTY AND EQUIPMENT

Property and equipment are reported at depreciated cost that is computed using the straight-line method based upon estimated useful lives of the assets.

LOSSES AND LOSS EXPENSES

The liability for losses and loss expenses includes amounts determined on the basis of estimates for losses reported prior to the close of the accounting period and other estimates, including those for incurred but not reported losses and salvage and subrogation recoveries.

These liabilities are continuously reviewed and updated by management, and management believes that such liabilities are adequate to cover the ultimate net cost of claims and expenses. When management determines that changes in estimates are required, such changes are included in current earnings.

We have no material exposures to environmental liabilities.

GUARANTY FUND LIABILITY ACCRUALS

We make estimates of our insurance subsidiaries' liabilities for guaranty fund and other assessments because of insurance company insolvencies from states in which the subsidiaries are licensed. Generally, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies. We generally record our liability for such assessments as premiums upon which those assessments are based are written. As a result of several large insolvencies in recent years, we are currently being assessed at the maximum level permitted by Pennsylvania law for several of our lines of business, and we expect we will continue to be assessed by Pennsylvania at the maximum level for these business lines for a number of years.

INCOME TAXES

We currently file a consolidated federal income tax return.

We account for income taxes using the asset and liability method. The objective of the asset and liability method is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the tax basis of our assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled.

CREDIT RISK

We provide property and liability coverages through our subsidiaries' independent agency systems located throughout our operating area. The majority of this business is billed directly to the insured, although a portion of our commercial business is billed through our agents, who are extended credit in the normal course of business.

Our subsidiaries have reinsurance agreements in place with the Mutual Company and with a number of other authorized reinsurers with at least an A.M.

Best rating of A- or an equivalent financial condition.

REINSURANCE ACCOUNTING AND REPORTING

We rely upon reinsurance agreements to limit our maximum net loss from large single risks or risks in concentrated areas, and to increase our capacity to write insurance. Reinsurance does not relieve the primary insurer from liability to its policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable under the terms of a reinsurance agreement, we are exposed to the risk of continued liability for such losses. However, in an effort to reduce the risk of non-payment, we require all of our reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition that, in the opinion of management, is equivalent to a company with at least an A- rating.

STOCK-BASED COMPENSATION

We account for stock-based compensation plans under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. During 2001, we adopted an Equity Incentive Plan for key employees that made 1,500,000 shares of Class A common stock available for issuance. The plan provides for the granting of awards by the Board of Directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. During 2001, we also adopted an Equity Incentive Plan for Directors that made 200,000 shares of Class A common stock available for issuance. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 175 shares of restricted stock to each director on the first business day of January in each year. No stock-based employee compensation is reflected in income, except for expense associated with restricted stock issued, as all options granted under those plans had an exercise price equal to, or greater than, the market value of the underlying common stock on the date of the grant. The following table illustrates the effect on net income and earnings per share as if we had applied the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (as amended by SFAS No. 148), "Accounting for Stock-Based Compensation."

	2003	2002	2001
Net income, as reported	$ 18,293,976	$ 12,002,722	$ 5,818,131
Less:			
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(30,814)	(234,935)	(200,358)
Pro-forma net income	$ 18,263,162	$ 11,767,787	$ 5,617,773
Basic earnings per share:			
As reported	$ 1.91	$ 1.32	$ .65
Pro-forma	1.91	1.30	.63
Diluted earnings per share:			
As reported	$ 1.85	$ 1.31	$ .64
Pro-forma	1.85	1.28	.62

The weighted-average grant date fair value of options granted for the various plans during 2000 was $2.23.

The fair values above were calculated based upon risk-free interest rates of 5.75% for the Stock Purchase Plans and the Equity Incentive Plans, expected lives of 6 months for the Stock Purchase Plans and 5 years for the Equity Incentive Plans, expected volatility of 54% for 2000 and an expected dividend yield of 4.5% for 2000.

EARNINGS PER SHARE

Basic earnings per share are calculated by dividing net income by the weighted-average number of common shares outstanding for the period, while diluted earnings per share reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

2--TRANSACTIONS WITH AFFILIATES

We conduct business and have various agreements with the Mutual Company that are described below:

a. REINSURANCE POOLING AND OTHER REINSURANCE ARRANGEMENTS

Atlantic States cedes to the Mutual Company all of its insurance business and assumes from the Mutual Company 70% of the Mutual Company's total pooled insurance business, including that assumed from Atlantic States and substantially all of the business assumed by the Mutual Company from Southern (prior to January 1, 2002). The Mutual Company and Atlantic States write business with different risk profiles. Through the pooling arrangement, each is able to share proportionately in the results of all policies written by the other. Atlantic States ceded premiums earned of $55,846,128, $45,229,457 and $37,345,259 and ceded losses and loss expenses incurred of $35,840,578, $34,471,381 and $29,094,804 under this arrangement during 2003, 2002 and 2001, respectively. It also assumed premiums earned of $153,068,026, $134,236,778 and $126,769,521 and assumed losses and loss expenses incurred of $99,677,221, $96,517,930 and $93,470,958 under this arrangement during 2003, 2002 and 2001, respectively. Atlantic States had prepaid reinsurance premiums of $29,981,597, $26,517,322 and $20,942,093 and a ceded liability for losses and loss expenses of $52,263,271, $47,862,627 and $39,321,214 under this arrangement as of December 31, 2003, 2002 and 2001, respectively. It also had assumed unearned premiums of $77,782,685, $69,208,310 and $63,636,858 and an assumed liability for losses and loss expenses of $121,297,553, $113,850,952 and $99,664,285 under this arrangement at December 31, 2003, 2002 and 2001, respectively.

Prior to January 1, 2002, the Mutual Company and Southern had a quota share agreement whereby Southern ceded 50% of its direct business, less reinsurance, to the Mutual Company. The business assumed by the Mutual Company from Southern became part of the pooling arrangement between the Mutual Company and Atlantic States. Southern ceded premiums earned of $0, $0 and $14,995,606 and ceded losses and loss expenses incurred of $(73,077), $488,055 and

$9,898,422 under this agreement during 2003, 2002 and 2001, respectively. Southern had prepaid reinsurance premiums of $0, $0 and $7,310,471 and a ceded liability for losses and loss expenses of $4,175,127, $6,399,727 and $10,068,604 under this agreement at December 31, 2003, 2002 and 2001, respectively. This agreement was terminated as of January 1, 2002.

Atlantic States and Southern each have a catastrophe reinsurance agreement with the Mutual Company that limits the maximum liability under any one catastrophic occurrence to $500,000 with a combined limit of $1,000,000 for a catastrophe involving both of the companies. Prior to merging into Atlantic States, Pioneer-Ohio, Delaware and Pioneer-New York each had a catastrophe reinsurance agreement with the Mutual Company that limited the maximum liability under any one catastrophic occurrence to $200,000, $300,000 and $400,000, respectively. Prior to merging into Southern, Southern Heritage had a catastrophe reinsurance agreement with the Mutual Company that limited the maximum liability under any one catastrophic occurrence to $400,000. Prior to merging into Atlantic States, Delaware and the Mutual Company had an excess of loss reinsurance agreement in which the Mutual Company assumed up to $250,000 of losses in excess of $50,000. Prior to merging into Atlantic States, Pioneer-Ohio and the Mutual Company had an excess of loss reinsurance agreement in which the Mutual Company assumed up to $250,000 ($200,000 in 2000) of losses in excess of $50,000. The Mutual Company and Southern have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $150,000 ($175,000 in 2002 and $50,000 in 2001) of losses in excess of $150,000 ($125,000 in 2002 and $100,000 in 2001). Prior to merging into Atlantic States, Pioneer-New York and the Mutual Company had an excess of loss reinsurance agreement in which the Mutual Company assumed up to $250,000 ($200,000 in 2000) of losses in excess of $50,000. Effective October 1, 2000 and prior to merging into Southern, Southern Heritage and the Mutual Company had an excess of loss reinsurance agreement in which the Mutual Company assumed up to $175,000 of losses in excess of $125,000. The Mutual Company has agreements in place with Southern (and Pioneer-Ohio and Delaware prior to merging into Atlantic States) to reallocate the loss results of workers' compensation business written by those companies as part of commercial accounts primarily written by the Mutual Company or Atlantic States. These agreements provide for the workers' compensation loss ratios of Southern to be no worse than the average workers' compensation loss ratio for all of the companies combined. The Mutual Company and Pioneer-New York also had an aggregate excess of loss reinsurance agreement in which the Mutual Company agreed to assume the adverse loss development of claims with dates of loss prior to December 31, 2000, as developed through December 31, 2002, and to assume losses in excess of a 60% loss ratio through December 31, 2002. The subsidiaries ceded premiums earned of $3,047,964, $2,811,359 and $2,439,520 and ceded losses and loss expenses incurred of $10,249,746, $6,873,539 and $4,194,251 under these various agreements during 2003, 2002 and 2001, respectively. The subsidiaries had a ceded liability for losses and loss expenses of $7,218,397, $6,397,326 and $5,395,528 under these various agreements at December 31, 2003, 2002, and 2001, respectively.

Southern (and Delaware, Pioneer-Ohio, Southern Heritage and and Pioneer-New York prior to mergers) has an agreement with the Mutual Company under which it cedes, and then reassumes back, 100% of its business net of reinsurance. The primary purpose of the agreement is to provide Southern with the same A.M. Best rating (currently "A") as the Mutual Company, which this subsidiary could not achieve without this contract in place. This agreement does not transfer insurance risk. While these subsidiaries ceded and reassumed amounts received from policyholders of $46,885,317, $48,921,377 and $41,142,936 and claims of $26,497,971, $28,859,644 and $23,348,952 under these agreements in 2003, 2002 and 2001, respectively, the amounts are not reflected in the consolidated financial statements. The aggregate liabilities ceded and reassumed under these agreements were $47,217,323 and $43,541,766 at December 31, 2003, and 2002, respectively.

b. EXPENSE SHARING

The Mutual Company provides facilities, management and other services to us, and we reimburse the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of us and the Mutual Company in the pooling arrangement, and our management and the management of the Mutual Company consider this allocation to be reasonable. Charges for these services totalled $33,047,769, $28,586,888 and $29,298,569 for 2003, 2002 and 2001, respectively.

c. LEASE AGREEMENT

We lease office equipment and automobiles with terms ranging from 3 to 10 years to the Mutual Company under a 10-year lease agreement dated January 1, 2000.

d. LEGAL SERVICES

Donald H. Nikolaus, President and one of our directors, is also a partner in the law firm of Nikolaus & Hohenadel. Such firm has served as our general counsel since 1986, principally in connection with the defense of claims litigation arising in Lancaster, Dauphin and York counties. Such firm is paid its customary fees for such services.

e. PROVINCE BANK

As of December 31, 2003, we had $5,661,089 in checking accounts with Province Bank, a wholly owned subsidiary of DFSC. We earned $24,972 in interest on these accounts during 2003.

3--INVESTMENTS

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2003 and 2002, are as follows:

	2003			
HELD TO MATURITY	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 29,130,684	$ 66,050	$ 368,967	$ 28,827,767
Canadian government				

obligation	499,630	25,370	--	525,000
Obligations of states and political subdivisions	45,187,284	1,117,513	60,847	46,243,950
Corporate securities	25,192,044	2,086,465	9	27,278,500
Mortgage-backed securities	13,041,142	287,732	71,089	13,257,785
Totals	$113,050,784	$ 3,583,130	$ 500,912	$116,133,002

	2003			
AVAILABLE FOR SALE	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 69,481,186	$ 1,094,878	$ 68,714	$ 70,507,350
Obligations of states and political subdivisions	81,104,794	3,281,260	604	84,385,450
Corporate securities	28,766,844	1,932,256	--	30,699,100
Mortgage-backed securities	12,744,548	99,886	2,997	12,841,437
Equity securities	29,644,333	1,897,441	93,553	31,448,221
Totals	$221,741,705	$ 8,305,721	$ 165,868	$229,881,558

2002				
HELD TO MATURITY	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 12,641,126	$ 407,958	$ --	$ 13,049,084
Canadian government obligation	499,250	40,750	--	540,000
Obligations of states and political subdivisions	33,891,385	574,768	66,463	34,399,690
Corporate securities	29,551,491	1,745,990	12,103	31,285,378
Mortgage-backed securities	10,118,304	393,857	995	10,511,166
Totals	$ 86,701,556	$ 3,163,323	$ 79,561	$ 89,785,318

2002				
AVAILABLE FOR SALE	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 56,344,340	$ 1,943,229	$ 337	$ 58,287,232
Obligations of states and political subdivisions	78,515,340	3,083,256	152,996	81,445,600
Corporate securities	34,848,807	2,016,526	2,783	36,862,550
Mortgage-backed securities	17,787,462	363,649	14,833	18,136,278
Equity securities	21,587,317	1,007,030	757,887	21,836,460
Totals	$209,083,266	$ 8,413,690	$ 928,836	$216,568,120

The amortized cost and estimated fair value of fixed maturities at December 31, 2003, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
HELD TO MATURITY		
Due in one year or less	$ 3,951,952	$ 4,048,500
Due after one year through five years	33,077,638	34,294,650
Due after five years through ten years	22,362,319	23,141,267
Due after ten years	40,617,733	41,390,800
Mortgage-backed securities	13,041,142	13,257,785
Total held to maturity	$ 113,050,784	$ 116,133,002
AVAILABLE FOR SALE		
Due in one year or less	$ 9,896,463	$ 10,100,250
Due after one year through five years	75,387,586	78,092,950
Due after five years through ten years	48,518,923	50,694,900
Due after ten years	45,549,852	46,703,800
Mortgage-backed securities	12,744,548	12,841,437
Total available for sale	$ 192,097,372	$ 198,433,337

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2003 and 2002, amounted to $5,095,211 and $5,400,597, respectively.

Net investment income, consisting primarily of interest and dividends, is attributable to the following sources:

	2003	2002	2001
Fixed maturities	$ 13,255,492	$ 14,285,049	$ 15,145,949
Equity securities	834,578	804,087	546,243
Short-term investments	523,527	564,738	920,538
Other	29,250	29,249	255,250
Investment income	14,642,847	15,683,123	16,867,980
Investment expenses	1,326,911	1,101,871	982,436
Net investment income	$ 13,315,936	$ 14,581,252	$ 15,885,544

Gross realized gains and losses from investments and the change in the difference between fair value and cost of investments, before applicable income taxes, are as follows:

	2003	2002	2001
Gross realized gains:			
Fixed maturities	$ 1,002,461	$ 128,714	$ 554,560
Equity securities	637,856	911,994	323,451
	1,640,317	1,040,708	878,011
Gross realized losses:			
Fixed maturities	33,759	106,789	28,618
Equity securities	238,527	789,729	1,729,647
	272,286	896,518	1,758,265
Net realized gains (losses)	$ 1,368,031	$ 144,190	$ (880,254)
Change in difference between fair value and cost of investments:			
Fixed maturities	$ (901,290)	$ 5,253,785	$ 3,498,259
Equity securities	1,554,745	(637,585)	1,275,050
	$ 653,455	$ 4,616,200	$ 4,773,309

Income taxes (benefit) on realized investment gains (losses) were $478,811, $49,565, and $(299,286) for 2003, 2002 and 2001, respectively. Deferred income taxes applicable to net unrealized investment gains included in shareholders' equity were $2,848,930 and $2,572,901 at December 31, 2003 and 2002, respectively.

We held available for sale fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2003 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 5,020,000	$ 68,714	$ --	$ --
Obligations of states and political subdivisions	525,000	604	--	--
Mortgage-backed securities	2,226,680	2,997	--	--
Equity securities	1,275,737	54,198	898,130	39,355
Totals	$ 9,047,417	$ 126,513	$ 898,130	$ 39,355

During 2003, 2002 and 2001, certain investments trading below cost had declined on an other-than-temporary basis. Losses of $237,724, $378,672 and $1,462,913 were included in net realized investment gains (losses) for these investments in 2003, 2002 and 2001, respectively.

During 2003, we sold certain bonds that had been classified as held to maturity due to a series of rating agency downgrades related to these securities. These bonds had an amortized cost of $1.8 million, and the sale resulted in a realized gain of $165,564. During 2002, we sold certain bonds that had been classified as held to maturity due to significant deterioration in the issuer's credit worthiness. These bonds had an amortized cost of $488,901, and the sale resulted in a realized loss of $73,901. There were no other sales or transfers from the held to maturity portfolio in 2003 or 2002. On January 1, 2001, we transferred investments with an amortized cost of $51,640,154 and fair value of $52,444,675 from the held to maturity classification to the available for sale classification under the provisions of SFAS No. 133 and 138. The unrealized holding gain of $804,521 at January 1, 2001 was reported in other comprehensive income. The transfer had no impact on net income.

We have no derivative instruments or hedging activities.

4--DEFERRED POLICY ACQUISITION COSTS

Changes in deferred policy acquisition costs are as follows:

	2003	2002	2001
Balance, January 1	$ 14,567,070	$ 13,604,215	$ 12,284,214
Acquisition costs deferred	32,495,695	30,435,855	28,514,001
Amortization charged to earnings	30,839,000	29,473,000	27,194,000
Balance, December 31	$ 16,223,765	$ 14,567,070	$ 13,604,215

5--PROPERTY AND EQUIPMENT

Property and equipment at December 31, 2003 and 2002, consisted of the following:

	2003	2002	Estimated Useful Life
Cost--office equipment	$ 5,293,302	$ 5,441,882	5-15 years
automobiles	903,162	785,572	3 years
real estate	2,676,636	3,105,851	15-50 years
software	325,323	561,146	5 years
	9,198,423	9,894,451	
Accumulated depreciation	(5,046,752)	(5,464,057)	
	$ 4,151,671	$ 4,430,394	

Depreciation expense for 2003, 2002, and 2001 amounted to $650,200, $690,263 and $829,100, respectively.

6--LIABILITY FOR LOSSES AND LOSS EXPENSES

Activity in the liability for losses and loss expenses is summarized as follows:

	2003	2002	2001
Balance at January 1	$ 210,691,752	$ 179,839,905	$ 156,476,124
Less reinsurance recoverable	79,583,319	65,295,790	53,766,710
Net balance at January 1	131,108,433	114,544,115	102,709,414
Incurred related to:			
Current year	126,693,421	122,433,653	110,142,467
Prior years	(450,110)	6,834,033	8,035,082
Total incurred	126,243,311	129,267,686	118,177,549
Paid related to:			
Current year	72,187,103	67,655,902	63,289,736
Prior years	46,268,571	45,047,466	43,053,112

Total paid	118,455,674	112,703,368	106,342,848
Net balance at December 31	138,896,070	131,108,433	114,544,115
Plus reinsurance recoverable	79,017,987	79,583,319	65,295,790
Balance at December 31	$ 217,914,057	$ 210,691,752	$ 179,839,905

We recognized an increase (decrease) in the liability for losses and loss expenses of prior years of $(450,110), $6.8 million and $8.0 million in 2003, 2002 and 2001, respectively. These developments are primarily attributable to variations from expected claim severity in the private passenger and commercial automobile liability, workers' compensation and commercial multiple peril lines of business.

7--BORROWINGS

LINE OF CREDIT

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year $35.0 million unsecured, revolving line of credit. As of December 31, 2003, we may borrow up to $35.0 million at interest rates equal to the bank's current prime rate or the then current London interbank Eurodollar bank rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our subsidiaries. As of December 31, 2003, there were no borrowings outstanding, and we complied with all requirements of the agreement.

At December 31, 2002, pursuant to a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank, we had unsecured borrowings of $19.8 million. Such borrowings were made in connection with various acquisitions and capital contributions to our subsidiaries. The borrowings under this line of credit were repaid during 2003, and this credit agreement was terminated on December 2, 2003.

SUBORDINATED DEBENTURES

On May 15, 2003, we received $15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At December 31, 2003, the interest rate on these debentures was 5.28%, next subject to adjustment on February 15, 2004. As of December 31, 2003, we have an equity interest of $464,000 in a trust and subordinated debentures of $15.5 million related to this transaction.

On October 29, 2003, we received $10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2003, the interest rate on these debentures was 5.01%, next subject to adjustment on January 29, 2004. As of December 31, 2003, we have an equity interest of $310,000 in a trust and subordinated debentures of $10.3 million related to this transaction.

8--REINSURERS

UNAFFILIATED REINSURERS

In addition to the reinsurance in place with the Mutual Company, our subsidiaries have other reinsurance in place, principally with four unaffiliated reinsurers. We monitor the financial strength of our unaffiliated reinsurers, requiring that companies rated by A.M. Best Company maintain a rating of A- or higher and that foreign reinsurers not rated by A.M. Best Company maintain a level of financial strength equivalent to companies qualifying for an A.M. Best Company rating of A- or higher. The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers during 2003, 2002 and 2001:

	2003	2002	2001
Premiums written	$ 10,908,851	$ 10,772,473	$ 9,348,853
Premiums earned	$ 11,535,468	$ 10,776,702	$ 9,440,035
Losses and loss expenses	$ 10,646,851	$ 13,693,184	$ 6,907,947
Prepaid reinsurance premiums	$ 710,057	$ 1,336,674	$ 1,340,903
Liability for losses and loss expenses	$ 15,361,192	$ 18,923,639	$ 10,510,444

TOTAL REINSURANCE

The following amounts represent the total of all ceded reinsurance transactions with both affiliated and unaffiliated reinsurers during 2003, 2002 and 2001:

	2003	2002	2001
Premiums earned	$ 70,429,560	$ 58,817,518	$ 64,220,420
Losses and loss expenses	$ 56,664,098	$ 55,526,159	$ 50,095,424
Prepaid reinsurance premiums	$ 30,691,654	$ 27,853,996	$ 29,593,467
Liability for losses and loss expenses	$ 79,017,987	$ 79,583,319	$ 65,295,790

The following amounts represent the effect of reinsurance on premiums written for 2003, 2002 and 2001:

	2003	2002	2001
Direct	$118,605,732	$111,767,756	$110,298,533
Assumed	161,642,112	139,814,138	135,830,624
Ceded	73,267,218	57,078,047	69,101,503
Net premiums written	$206,980,626	$194,503,847	$177,027,654

The following amounts represent the effect of reinsurance on premiums earned for 2003, 2002 and 2001:

	2003	2002	2001
Direct	$114,154,202	$110,412,498	$105,214,059
Assumed	153,068,054	134,246,213	126,776,215
Ceded	70,429,560	58,817,518	64,220,420
Net premiums earned	$196,792,696	$185,841,193	$167,769,854

9--INCOME TAXES

The provision for income tax consists of the following:

	2003	2002	2001
Current	$ 7,495,130	$ 5,071,516	$ 2,634,231
Deferred	(352,731)	(579,654)	(1,360,633)
Federal tax provision	$ 7,142,399	$ 4,491,862	$ 1,273,598

The effective tax rate is different from the amount computed at the statutory federal rate of 35% for 2003 and 34% for 2002 and 2001. The reasons for such difference and the related tax effects are as follows:

	2003	2002	2001
Income before income taxes	$ 25,436,375	$ 16,494,584	$ 7,091,729
Computed "expected" taxes	8,902,731	5,608,159	2,411,188
Tax-exempt interest	(1,824,830)	(1,304,197)	(1,399,238)
Dividends received deduction	(49,147)	(31,830)	(21,908)
Other, net	113,645	219,730	283,556
Federal income tax provision	$ 7,142,399	$ 4,491,862	$ 1,273,598

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2003 and 2002, are as follows:

	2003	2002
Deferred tax assets:		
Unearned premium	$ 7,246,680	$ 6,438,461
Loss reserves	5,943,747	5,786,195
Net operating loss carryforward - Southern Heritage	1,459,722	1,744,081
Other	1,449,747	1,133,488
Total	$ 16,099,896	$ 15,102,225
Deferred tax liabilities:		
Depreciation expense	$ 331,291	$ 343,362
Deferred policy acquisition costs	5,678,318	5,007,431
Salvage recoverable	208,948	222,824
Unrealized gain	2,848,930	2,572,901
Total	$ 9,067,487	$ 8,146,518
Net deferred tax assets	$ 7,032,409	$ 6,955,707

A valuation allowance is provided when it is more likely than not that some portion of the tax asset will not be realized. Management has determined that it is not required to establish a valuation allowance for any deferred tax asset at December 31, 2003, since it is more likely than not that the deferred tax assets will be realized through reversals of existing temporary differences, future taxable income, carryback to taxable income in prior years and the implementation of tax planning strategies.

At December 31, 2003, we have a net operating loss carryforward of $4,170,635, which is available to offset our taxable income. Such net operating loss carryforward will expire beginning in 2009. Federal income tax laws limit the amount of net operating loss carryforward that we can use in any one year to approximately $1 million.

10--STOCKHOLDERS' EQUITY

On April 19, 2001 our stockholders approved an amendment to our Certificate of Incorporation. Among other things, the amendment reclassified our common stock as Class B common stock and effected a one-for-three reverse split of our Class B common stock effective April 19, 2001. The amendment also authorized a new class of common stock with one-tenth of a vote per share designated as Class A common stock. Our Board also approved a dividend of two shares of Class A common stock for each share of Class B common stock, after the one-for-three reverse split, held of record at the close of business April 19, 2001. The effect of the reverse split and the stock dividend taken together is that we had the same total number of shares outstanding after the reverse split and the stock dividend as we did before the reverse split and the stock dividend. Therefore, there is no change in the historical earnings per share of the Class A common stock and the Class B common stock after the reverse split and the stock dividend compared to before the reverse split and the stock dividend.

Each share of Class A common stock outstanding at the time of the declaration of any dividend or other distribution payable in cash upon the shares of Class B common stock is entitled to a dividend or distribution payable at the same time and to stockholders of record on the same date in an amount at least 10% greater than any dividend declared upon each share of Class B common stock. In the event of our merger or consolidation with or into another entity, the holders of Class A common stock and the holders of Class B common stock are entitled to receive the same per share consideration in such merger or consolidation. In the event of our liquidation, dissolution or winding-up, any assets available to common stockholders will be distributed pro-rata to the holders of Class A common stock and Class B common stock.

11--STOCK COMPENSATION PLANS

EQUITY INCENTIVE PLANS

During 1996, we adopted an Equity Incentive Plan for key employees. During 2001, we adopted a nearly identical plan that made a total of 1,500,000 shares of Class A common stock available for issuance. Each plan provides for the granting of awards by the Board of Directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. The plans provide that stock options may become exercisable up to 10 years from date of grant, with an option price not less than fair market value on date of grant. The stock appreciation rights permit surrender of the option and receipt of the excess of current market price over option price in cash. No stock appreciation rights have been issued.

During 1996, we adopted an Equity Incentive Plan For Directors. During 2001, we adopted a nearly identical plan that made 200,000 shares of Class A common stock available for issuance. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 175 shares of restricted stock to each director on the first business day of January in each year. As of December 31, 2003, we have 40,000 unexercised options under these plans. Additionally 1,925, 2,100 and 1,947 shares of restricted stock were issued on January 2, 2003, 2002 and 2001, respectively.

All options issued prior to 2001 were converted to options on Class A and Class B common stock as a result of our recapitalization. No further shares are available for plans in effect prior to 2001.

Information regarding activity in our stock option plans is presented below:

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2000	1,516,338	$ 13.19
Granted - 2001	459,000	13.93
Exercised - 2001	13,315	8.00
Forfeited - 2001	27,556	13.50
Outstanding at December 31, 2001	1,934,467	$ 13.27
Granted - 2002	10,000	14.00
Exercised - 2002	7,684	8.00
Forfeited - 2002	18,334	14.36
Expired - 2002	524,448	13.50

Outstanding at December 31, 2002	1,394,001	$ 13.43
Granted - 2003	667,500	12.00
Exercised - 2003	91,482	8.15
Forfeited - 2003	14,000	10.57
Expired - 2003	476,667	18.00
Outstanding at December 31, 2003	1,479,352	$ 11.72
Exercisable at:		
December 31, 2001	1,321,905	$ 13.89
December 31, 2002	1,085,000	$ 13.29
December 31, 2003	883,707	$ 11.11

Options available for future grants at December 31, 2003 are 577,975.

The following table summarizes information about fixed stock options at December 31, 2003:

Exercise Price	Number of Options Outstanding	Weighted-Average Remaining Contractual Life	Number of Options Exercisable
$ 8.00	353,585	1.0 year	353,585
9.00	4,500	2.5 years	4,500
12.00	650,668	4.5 years	216,889
14.00	455,599	2.5 years	303,733
18.00	5,000	1.5 years	5,000
18.25	5,000	4.5 years	--
21.00	5,000	5.0 years	--
Total	1,479,352		883,707

EMPLOYEE STOCK PURCHASE PLANS

During 1996, we adopted an Employee Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 300,000 shares of Class A common stock available for issuance.

The new plan extends over a 10-year period and provides for shares to be offered to all eligible employees at a purchase price equal to the lesser of 85% of the fair market value of our common stock on the last day before the first day of the enrollment period (June 1 and December 1) of the plan or 85% of the fair market value of our common stock on the last day of the subscription period (June 30 and December 31). A summary of plan activity follows:

	Shares Issued	
	Price	Shares
January 1, 2001	$ 5.9500	16,438
July 1, 2001	8.7125	11,377
January 1, 2002	8.8485	12,769
July 1, 2002	8.7720	10,520
January 1, 2003	9.1375	9,425
July 1, 2003	10.1575	8,776

On January 1, 2004, we issued an additional 7,637 shares at a price of $11.4495 per share under this plan.

AGENCY STOCK PURCHASE PLANS

On December 31, 1996, we adopted an Agency Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 300,000 shares of Class A common stock available for issuance. The plan provides for agents of our affiliated companies to invest up to $12,000 per subscription period (April 1 to September 30 and October 1 to March 31) under various methods. Stock is issued at the end of the subscription period at a price equal to 90% of the average market price during the last ten trading days of the subscription period. During 2003, 2002 and 2001, 28,547, 16,310, and 16,557 shares, respectively, were issued under this plan. Expense recognized under the plan was not material.

12--STATUTORY NET INCOME, CAPITAL AND SURPLUS AND DIVIDEND RESTRICTIONS

The following is selected information, as filed with insurance regulatory authorities, for our subsidiaries as determined in accordance with accounting practices prescribed or permitted by such insurance regulatory authorities:

	2003	2002	2001
ATLANTIC STATES			
Statutory capital and surplus	$109,854,398	$ 95,405,603	$ 91,649,362
Statutory unassigned surplus	$ 56,193,534	$ 46,744,739	$ 42,988,498
Statutory net income (loss)	$ 13,272,651	$ 10,646,804	$ (676,125)
SOUTHERN			
Statutory capital and surplus	$ 40,649,495	$ 31,243,897	$ 30,730,757
Statutory unassigned surplus	$ (1,968,090)	$ (6,373,688)	$ (6,886,828)
Statutory net income	$ 5,275,909	$ 2,505,891	$ 5,180,964

Our principal source of cash for payment of dividends are dividends from our subsidiaries which are required by law to maintain certain minimum capital and surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States and Southern are also subject to Risk Based Capital (RBC) requirements that may further impact their ability to pay dividends. At December 31, 2003, the companies' statutory capital and surplus were substantially above the RBC requirements. Amounts available for distribution as dividends to us without prior approval of insurance regulatory authorities in 2004 are $13,272,651 from Atlantic States and $4,064,950 from Southern.

The National Association of Insurance Commissioners (NAIC) adopted the Codification of Statutory Accounting Principles with an effective date of January 1, 2001. The codified principles are intended to provide a basis of accounting recognized and adhered to in the absence of conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the statutory capital and surplus of our subsidiaries as of January 1, 2001 was as follows: Atlantic States - $6,482,380 increase and Southern - $2,254,558 increase.

13--RECONCILIATION OF STATUTORY FILINGS TO AMOUNTS REPORTED HEREIN

Our subsidiaries are required to file statutory financial statements with state insurance regulatory authorities. Accounting principles used to prepare these statutory financial statements differ from financial statements prepared on the basis of generally accepted accounting principles.

Reconciliations of statutory net income and capital and surplus, as determined using statutory accounting principles, to the amounts included in the accompanying financial statements are as follows:

	Year Ended December 31,		
	2003	2002	2001
Statutory net income of insurance subsidiaries	$ 18,548,560	$ 13,152,695	$ 4,504,839
Increases (decreases):			
Deferred policy acquisition costs	1,656,695	962,855	1,320,001
Deferred federal income taxes	352,731	579,654	1,360,633
Salvage and subrogation recoverable	(167,627)	(863,313)	155,088
Consolidating eliminations and adjustments	(8,099,197)	(11,264,732)	(13,783,695)
Parent-only net income	6,002,814	9,435,563	12,261,265
Net income as reported herein	$ 18,293,976	$ 12,002,722	$ 5,818,131

	December 31, 2003	2002	2001
Statutory capital and surplus of insurance subsidiaries	$ 150,503,893	$ 126,649,500	$ 122,380,119
Increases (decreases):			
Deferred policy acquisition costs	16,223,765	14,567,070	13,604,215
Deferred federal income taxes	(4,268,453)	(3,499,656)	(820,313)
Salvage and subrogation recoverable	7,167,008	7,334,635	8,197,948
Non-admitted assets and other adjustments, net	907,955	735,946	334,092
Fixed maturities	6,521,246	7,517,290	3,793,048
Consolidating eliminations and adjustments	(51,984,856)	(40,891,418)	(39,693,089)
Parent-only equity	83,578,674	20,769,483	13,132,329
Stockholders' equity as reported herein	$ 208,649,232	$ 133,182,850	$ 120,928,349

14--SUPPLEMENTARY CASH FLOW INFORMATION

The following reflects income taxes and interest paid during 2003, 2002 and 2001:

	2003	2002	2001
Income taxes	$ 7,356,674	$ 4,410,000	$ 2,666,887
Interest	$ 1,291,992	$ 1,047,237	$ 3,049,844

15--EARNINGS PER SHARE

The following information illustrates the computation of net income, outstanding shares and earnings per share on both a basic and diluted basis for the years ended December 31, 2003, 2002 and 2001:

	Net Income	Weighted-Average Shares Outstanding	Earnings Per Share
2003:			
Basic	$18,293,976	9,570,872	$1.91
Effect of stock options	--	323,972	(.06)
Diluted	$18,293,976	9,894,844	$1.85
2002:			
Basic	$12,002,722	9,085,914	$1.32
Effect of stock options	--	107,199	(.01)
Diluted	$12,002,722	9,193,113	$1.31
2001:			
Basic	$ 5,818,131	8,941,781	$ .65
Effect of stock options	--	136,669	(.01)
Diluted	$ 5,818,131	9,078,450	$ .64

The following options to purchase shares of common stock were not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price:

	2003	2002	2001
Options excluded from diluted earnings per share	--	939,167	1,467,782

16--CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

CONDENSED BALANCE SHEETS
($ in thousands)

December 31,	2003	2002
ASSETS		
Fixed-maturity investments	$ 1,987	$ --
Investment in subsidiaries (equity method)	183,402	156,684
Short-term investments	47,559	--
Cash	365	604
Property and equipment	1,579	1,640
Other	1,345	99
Total assets	$ 236,237	$ 159,027
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Cash dividends declared to stockholders	$ 1,379	$ 887
Line of credit	--	19,800
Subordinated debentures	25,774	--
Due to affiliate	--	4,441
Other	435	716
Total liabilities	27,588	25,844
Stockholders' equity	208,649	133,183
Total liabilities and stockholders' equity	$ 236,237	$ 159,027

CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
($ in thousands)

Year Ended December 31,	2003	2002	2001
STATEMENTS OF INCOME			
Revenues			
Dividends from subsidiaries	$ 7,000	$ 10,400	$ 14,419
Other	1,034	797	824
Total revenues	8,034	11,197	15,243
Expenses			
Operating expenses	1,345	1,057	1,761
Interest	1,320	1,139	2,288
Total expenses	2,665	2,196	4,049
Income before income tax benefit and equity in undistributed net income (loss) of subsidiaries	5,369	9,001	11,194
Income tax benefit	(634)	(435)	(1,067)
Income before equity in undistributed net income (loss) of subsidiaries	6,003	9,436	12,261
Equity in undistributed net income (loss) of subsidiaries	12,291	2,567	(6,443)
Net income	$ 18,294	$ 12,003	$ 5,818
STATEMENTS OF COMPREHENSIVE INCOME			
Net income	$ 18,294	$ 12,003	$ 5,818
Other comprehensive income, net of tax			
Unrealized gain (loss) - parent	(42)	15	26
Unrealized gain - subsidiaries	421	2,035	3,035
Other comprehensive income	379	2,050	3,061
Comprehensive income	$ 18,673	$ 14,053	$ 8,879

CONDENSED STATEMENTS OF CASH FLOWS
($ in thousands)

Year Ended December 31,	2003	2002	2001
Cash flows from operating activities:			
Net income	$ 18,294	$ 12,003	$ 5,818
Adjustments:			
Equity in undistributed net loss (income) of subsidiaries	(12,291)	(2,567)	6,443
Other	(4,316)	788	252
Net adjustments	(16,607)	(1,779)	6,695
Net cash provided	1,687	10,224	12,513
Cash flows from investing activities:			
Net purchase of fixed maturities	(1,938)	--	--
Net purchase of short-term investments	(47,559)	--	--
Net purchase of property and equipment	(433)	(480)	(122)
Investment in subsidiaries	(14,274)	--	--
Other	(981)	38	38
Net cash used	(65,185)	(442)	(84)
Cash flows from financing activities:			
Cash dividends paid	(3,868)	(3,509)	(3,394)
Issuance of common stock	61,153	1,728	1,387
Issuance of subordinated debentures	25,774	--	--
Line of credit, net	(19,800)	(7,800)	(12,400)
Net cash provided (used)	63,259	(9,581)	(14,407)
Net change in cash	(239)	201	(1,978)
Cash at beginning of year	604	403	2,381
Cash at end of year	$ 365	$ 604	$ 403

17--SEGMENT INFORMATION

As an underwriter of property and casualty insurance, we have three reportable segments which consist of the investment function, the personal lines of insurance and the commercial lines of insurance. Using independent agents, we market personal lines of insurance to individuals and commercial lines of insurance to small and medium-sized businesses.

We evaluate the performance of the personal lines and commercial lines primarily based upon underwriting results as determined under statutory accounting practices (SAP) for our total business.

Assets are not allocated to the personal and commercial lines and are reviewed in total by management for purposes of decision making. We operate only in the United States and no single customer or agent provides 10 percent or more of revenues.

Financial data by segment is as follows:

	2003	2002	2001
	($ in thousands)		
Revenues:			
Premiums earned:			
Commercial lines	$ 71,471	$ 66,003	$ 62,877
Personal lines	125,322	119,838	104,893
Total premiums earned	196,793	185,841	167,770
Net investment income	13,316	14,581	15,886
Realized investment gains (losses)	1,368	144	(880)
Other	3,515	3,238	2,388
Total revenues	$ 214,992	$ 203,804	$ 185,164

	2003	2002	2001
	($ in thousands)		
Income before income taxes:			
Underwriting income (loss):			
Commercial lines	$ 7,173	$ 6,326	$ (3,037)
Personal lines	2,004	(5,056)	(5,090)
SAP underwriting income (loss)	9,177	1,270	(8,127)
GAAP adjustments	692	(558)	1,833
GAAP underwriting income (loss)	9,869	712	(6,294)
Net investment income	13,316	14,581	15,886
Realized investment gains (losses)	1,368	144	(880)
Other	883	1,058	(1,620)
Income before income taxes	$ 25,436	$ 16,495	$ 7,092

18--GUARANTY FUND AND OTHER INSURANCE-RELATED ASSESSMENTS

We accrue for guaranty-fund and other insurance-related assessments in accordance with Statement of Position (SOP) 97-3, "Accounting by Insurance and Other Enterprises for Insurance-Related Assessments." SOP 97-3 provides guidance for determining when an entity should recognize a liability for guaranty-fund and other insurance-related assessments, how to measure that liability and when an asset may be recognized for the recovery of such assessments through premium tax offsets or policy surcharges. Our liabilities for guaranty-fund and other insurance-related assessments were $3,556,227 and $2,970,182 at December 31, 2003 and 2002, respectively. These liabilities included $283,509 and $538,578 related to surcharges collected by us on behalf of regulatory authorities for 2003 and 2002, respectively.

19--INTERIM FINANCIAL DATA (UNAUDITED)

	2003			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$47,928,881	$48,433,689	$49,719,584	$50,710,542
Total revenues	52,185,419	52,826,818	54,285,753	55,694,338
Net losses and loss expenses	31,850,515	29,658,466	32,759,356	31,974,974
Net income	3,844,432	5,268,953	4,001,385	5,179,206
Net income per common share				
Basic	.42	.57	.43	.49
Diluted	.41	.56	.40	.47

	2002			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$45,452,260	$46,110,512	$46,792,748	$47,485,673
Total revenues	50,034,046	50,736,803	51,085,417	51,947,295
Net losses and loss expenses	31,297,569	32,136,019	32,423,893	33,410,205
Net income	2,180,716	3,178,834	3,015,676	3,627,496
Net income per common share				
Basic	.24	.35	.33	.40
Diluted	.24	.35	.33	.39

INDEPENDENT AUDITORS' REPORT

The Stockholders and Board of Directors

Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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 Donegal Group Inc. and subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

/s/ KPMG LLP
Philadelphia, Pennsylvania
February 19, 2004

CORPORATE INFORMATION

ANNUAL MEETING

April 15, 2004 at the Company's headquarters at 10:00 a.m.

FORM 10-K

A copy of Donegal Group's Annual Report on Form 10-K will be furnished free upon written request to Ralph G. Spontak, Senior Vice President and Chief Financial Officer, at the corporate address.

MARKET INFORMATION

Donegal Group's Class A common stock and Class B common stock are traded on the Nasdaq National Market under the symbols "DGICA" and "DGICB." The following table shows the dividends paid per share and the stock price range for each quarter during 2003 and 2002:

QUARTER	HIGH	LOW	CASH DIVIDEND DECLARED PER SHARE
2002 - CLASS A			
1st	$ 10.770	$ 8.750	$ --
2nd	12.250	9.050	.10
3rd	10.990	9.120	.10
4th	12.120	9.250	.20
2002 - CLASS B			
1st	12.800	8.780	--
2nd	11.000	9.750	.09
3rd	11.500	9.510	.09
4th	11.440	9.200	.18
2003 - CLASS A			
1st	11.750	9.500	--
2nd	15.200	10.980	.10
3rd	19.000	12.100	.11
4th	23.970	15.250	.22
2003 - CLASS B			
1st	11.320	10.720	--
2nd	13.790	10.350	.09
3rd	16.010	11.760	.10
4th	20.000	14.750	.20

CORPORATE OFFICES

1195 River Road
P.O. Box 302
Marietta, Pennsylvania 17547-0302
(800) 877-0600
E-mail Address: info@donegalgroup.com
Donegal Web Site: www.donegalgroup.com

TRANSFER AGENT

EquiServe Trust Company, N.A.
P.O. Box 43069
Providence, Rhode Island 02940-3069
(800) 317-4445
Web Site: www.equiserve.com
Hearing Impaired: TDD: 800-952-9245

DIVIDEND REINVESTMENT AND STOCK PURCHASE PLAN

The Company offers a dividend reinvestment and stock purchase plan through its transfer agent.

For information contact:

Donegal Group Inc.
Dividend Reinvestment and Stock Purchase Plan
EquiServe Trust Company, N.A.
P.O. Box 43069
Providence, Rhode Island 02940-3069

STOCKHOLDERS

The following represent the number of common stockholders of record as of December 31, 2003:

Class A common stock 638
Class B common stock 479

DONEGAL GROUP INC.

CODE OF ETHICS

This Code of Ethics of the Company applies to the Chief Executive Officer, the Chief Financial Officer, the Chief Accounting Officer, the Treasurer and the Controller of the Company (each, a "Covered Person"). The Covered Persons hold important roles in corporate governance. This Code of Ethics is designed to deter wrongdoing and promote ethical conduct and compliance with applicable laws and regulations.

Each Covered Person has the obligation to:

a) Engage in and promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

b) Produce full, fair, accurate, timely and understandable disclosure in reports and documents that the Company or its subsidiaries file with, or submit to, the Securities and Exchange Commission and other regulators and in other public communications made by the Company or its subsidiaries;

c) Comply with applicable governmental laws, rules and regulations, as well as the rules and regulations of the Nasdaq Stock Market; and

d) Promptly report any possible violation of this Code of Ethics to the Audit Committee or any of the persons designated from time to time by the Company's Board of Directors for such purposes.

Each Covered Person is prohibited from directly or indirectly taking any action to fraudulently influence, coerce, manipulate or mislead the Company or its subsidiaries' independent public accountants for the purpose of rendering the financial statements of the Company or its subsidiaries misleading.

Each Covered Person will be held accountable for the Covered Person's adherence to this Code of Ethics. Failure to observe the terms of this Code of Ethics may result in disciplinary action, up to and including termination of employment. Violations of this Code of Ethics may also constitute violations of law and may result in civil and criminal penalties for the Covered Person, his or her supervisors or the Company.

Reporting any possible violation of this Code of Ethics may be made anonymously. Questions regarding the best course of action in a particular situation should promptly be directed to Donald H. Nikolaus, President and Chief Executive Officer, with a copy to the Company's chief legal officer.

As adopted by the Board of Directors on March 19, 2004.

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EXHIBIT 21

SUBSIDIARIES OF REGISTRANT

Registrant owns 100% of the outstanding stock of the following insurance companies:

Name	State of Formation
Atlantic States Insurance Company	Pennsylvania
Southern Insurance Company of Virginia	Virginia

EXHIBIT 23

INDEPENDENT AUDITORS' CONSENT AND REPORT ON SCHEDULES

The Board of Directors

Donegal Group Inc.:

The audits referred to in our report dated February 19, 2004 include the related financial statement schedules as of December 31, 2003, and for each of the years in the three-year period ended December 31, 2003, included in the annual report on Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We consent to incorporation by reference in the registration statements (Nos. 333-06681, 333-25541, 333-26693, 333-61095, 333-93785, 333-94301, 333-89644, 333-62970, 333-62974 and 333-62976) on Form S-8 and registration statement (No. 333-59828) on Form S-3 of Donegal Group Inc. of our reports dated February 19, 2004, with respect to the consolidated balance sheets of Donegal Group Inc. as of December 31, 2003 and 2002, and the related consolidated statements of income and comprehensive income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2003, and all related financial statement schedules, which reports are incorporated by reference or appear in the December 31, 2003 annual report on Form 10-K of Donegal Group Inc.

/s/ KPMG LLP

Philadelphia, Pennsylvania

March 22, 2004

EXHIBIT 31.1

CERTIFICATION

I, Donald H. Nikolaus, President of Donegal Group Inc., certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2003 of Donegal Group Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Donald H. Nikolaus

Donald H. Nikolaus, President

Date: March 26, 2004

EXHIBIT 31.2

CERTIFICATION

I, Ralph G. Spontak, Senior Vice President, Chief Financial Officer and Secretary of Donegal Group Inc., certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2003 of Donegal Group Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Ralph G. Spontak

Ralph G. Spontak, Senior Vice President
Chief Financial Officer and Secretary

Date: March 26, 2004

EXHIBIT 32.1

Statement of President
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, I, Donald H. Nikolaus, the President of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-K Annual Report for the period ended December 31, 2003 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Donald H. Nikolaus

Donald H. Nikolaus, President

Date: March 26, 2004

EXHIBIT 32.2

Statement of Chief Financial Officer
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, I, Ralph G. Spontak, Senior Vice President and Chief Financial Officer of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-K Annual Report for the period ended December 31, 2003 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Ralph G. Spontak

Ralph G. Spontak, Senior Vice President
Chief Financial Officer and Secretary

Date: March 26, 2004