UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2006

OR

o **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:

Title of Class	Name of Exchange on Which Registered
Class A Common Stock, $.01 par value	The NASDAQ Stock Market LLC
Class B Common Stock, $.01 par value	The NASDAQ Stock Market LLC

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes o No ☑

Indicate by check mark whether the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act: Yes o No ☑

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 Yes ☑ No o

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. ☑

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

Large accelerated filer o Accelerated filer ☑ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company. Yes o No ☑

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. $253,979,442.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 19,715,101 shares of Class A Common Stock and 5,576,775 shares of Class B Common Stock were outstanding on February 26, 2007.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the registrant's annual report to stockholders for the fiscal year ended December 31, 2006 are incorporated by reference into Parts I, II and IV of this report.
2. Portions of the registrant's proxy statement relating to registrant's annual meeting of stockholders to be held April 19, 2007 are incorporated by reference into Part III of this report.

DONEGAL GROUP INC.
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2006 Annual Report to Stockholders
Subsidiaries of Registrant
Report and Consent of Independent Registered Public Accounting Firm
Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer
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PART I

Item 1. Business.

(a) 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 18 Mid-Atlantic, Midwestern and Southeastern states. Our insurance subsidiaries provide their policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline. At December 31, 2006, we had total assets of $831.7 million and stockholders' equity of $320.8 million. Our net income was $40.2 million for the year ended December 31, 2006 compared to $36.9 million for the year ended December 31, 2005.

Donegal Mutual Insurance Company ("Donegal Mutual") owns approximately 41% of our Class A common stock and approximately 70% of our Class B common stock. The operations of our insurance subsidiaries are interrelated with the operations of Donegal Mutual and, while maintaining the separate corporate existence of each company, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries have the same business philosophy, the same management, the same employees, the same facilities 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, Donegal Mutual purchases a surplus note from a mutual insurance company and/or Donegal Mutual enters into a management agreement with the mutual insurance company and, in either circumstance, Donegal Mutual's designees are appointed as a majority of the mutual insurance company's board of directors.
  - Second, the mutual insurance company is converted into a stock insurance company. At the effective date of the conversion, we purchase the surplus note from Donegal Mutual and acquire the stock of the stock insurance company resulting from the conversion of the mutual company.

We believe that our ability to make direct acquisitions or to structure acquisitions through Donegal Mutual surplus note and/or management agreement 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 Donegal Mutual makes a surplus note investment in another company and/or enters into a management agreement with it, the financial results of that company are not consolidated with our financial results or those of Donegal Mutual, and neither we nor Donegal Mutual are responsible for the insurance obligations of that company, except to the extent that we reinsure the other company.

While we generally are engaged in preliminary discussions with potential acquisition candidates on a continuous basis and are so at the date of this Form 10-K Annual Report, we do not make any public disclosure regarding an acquisition until we have entered into a definitive acquisition agreement.

We did not complete any acquisitions in 2006; however, on December 27, 2006, Donegal Mutual entered into a Contribution Note Purchase Agreement (the “Purchase Agreement”) with Sheboygan Falls Mutual Insurance Company (“Sheboygan Falls”). Consummation of the transaction is subject to regulatory approval. Under the Purchase Agreement:

- Donegal Mutual will purchase a contribution note of $3.5 million from Sheboygan Falls;
- Designees of Donegal Mutual will constitute six of the ten members of the board of directors of Sheboygan Falls; and
- Donegal Mutual will provide services to Sheboygan Falls in key functions, including underwriting, claims, reinsurance, investments, data processing, personnel, professional services and financial reporting.

On September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, “Shelby”), part of Vesta Insurance Group, Inc. The agreement granted those members the right, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby’s personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby’s withdrawal from those three states. During 2006, the members of the Donegal Insurance Group paid $805,378 to Shelby based on the direct premiums written by the Donegal Insurance Group. Net premiums written by the members of the Donegal Insurance Group related to this agreement were approximately $6.3 million in 2006 and $0 in 2005.

(b) Financial Information About Industry Segments.

Our insurance subsidiaries have three segments: investments, personal lines of insurance and commercial lines of insurance. Financial information about these segments is set forth in Note 19 to our Consolidated Financial Statements incorporated by reference herein.

(c) 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 18 Mid-Atlantic, Midwestern and Southeastern states. Our insurance subsidiaries provide their policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline.

Our insurance subsidiaries derive a substantial portion of their insurance business from smaller to mid-sized regional communities. We believe this focus provides our insurance subsidiaries with competitive advantages in terms of local market knowledge, marketing, underwriting, claims servicing and policyholder service. At the same time, we believe our insurance subsidiaries have cost advantages over many regional insurers because of the centralized accounting, administrative, investment and other services available to our insurance subsidiaries where economies of scale can make a significant difference.

Strategy

Our insurance subsidiaries have increased their annual premiums earned from $167.8 million in 2001 to $301.5 million in 2006, a compound annual growth rate of 12%. Over the same time period, the combined ratio of our insurance subsidiaries has consistently been more favorable than that of the property and casualty insurance industry as a whole. Our insurance subsidiaries seek to grow their business and enhance their profitability by:

- *Achieving underwriting profitability.*

Our insurance subsidiaries focus on achieving a combined ratio of less than 100%. We believe that underwriting profitability is a fundamental component of our long-term financial strength because it allows our insurance subsidiaries to generate profits without relying on their investment income. Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite, minimizing their exposure to catastrophe-prone areas and evaluating their claims history on a regular basis to ensure the adequacy of their underwriting guidelines and product pricing. Our insurance subsidiaries have no material exposures to asbestos and environmental liabilities. Our insurance

subsidiaries seek to provide more than one policy to a given personal or commercial customer because this "account selling" strategy diversifies their risk and has historically improved their underwriting results. Finally, our insurance subsidiaries use reinsurance to manage their exposure and limit their maximum net loss from large single risks or risks in concentrated areas. Our insurance subsidiaries believe these practices are key factors in their ability to maintain a combined ratio that has been traditionally more favorable than the combined ratio of the property and casualty insurance industry.

The combined ratio of our insurance subsidiaries and that of the property and casualty insurance industry for the years 2001 through 2006 are shown in the following table:

	2001	2002	2003	2004	2005	2006
Donegal GAAP combined ratio	103.8%	99.6%	95.0%	93.1%	89.5%	89.0%
Industry SAP combined ratio(1)	115.9	107.3	100.2	98.5	100.8	93.3

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

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

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

- *Acquiring property and casualty insurance companies to augment the organic growth of our insurance subsidiaries 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 our insurance subsidiaries are currently conducting business or offer an attractive opportunity to conduct profitable business;
- A mix of business similar to the business of our insurance subsidiaries;
- Targeted premium volume between $20.0 million and $100.0 million; and
- Transaction terms that are fair and reasonable to us.

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

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

Our insurance subsidiaries maintain stringent expense controls under direct supervision by their senior management. We consolidate many processing and administrative activities of our insurance subsidiaries at our home office to realize operating synergies and better control expenses. Our insurance subsidiaries utilize technology to automate much of their underwriting and to facilitate agency and policyholder communications on an efficient and cost-effective basis. As a result of our focus on expense control, our insurance subsidiaries have reduced their expense ratio from 36.6% for 1999 to 32.7% for 2006, notwithstanding performance-based compensation paid to agents in 2006 of $9.8 million compared to $4.0 million in 1999. Our insurance subsidiaries have also increased their annual premium per employee, a measure of efficiency that our insurance subsidiaries use to evaluate their operations, from approximately $470,000 in 1998 to approximately $733,000 in 2006.

Our insurance subsidiaries strive to possess and utilize technology comparable to that of the largest of their competitors. “Ease of doing business” has become an increasingly important component of an insurer’s value to an independent agency. We have implemented a fully automated personal lines underwriting and policy issuance system, which our

insurance subsidiaries refer to as "WritePro®". WritePro® is a web-based user interface that substantially improves the ease of data entry and facilitates the quoting and issuance of policies for agents. We have also implemented a similar commercial business system, which our insurance subsidiaries refer to as "WriteBiz®." WriteBiz® is an automated underwriting system that provides agents for our insurance subsidiaries with a web-based interface to quote and issue commercial automobile, workers' compensation, businessowners and tradesman policies automatically. As a result, applications from agents can be quickly transitioned to policies without further re-entry of information, and policy information is then fully downloaded to agents' policy management systems through existing download capabilities.

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

We believe that excellent policyholder service is important to attracting new policyholders and retaining existing policyholders. Our insurance subsidiaries work closely with their agency force to provide a consistently responsive level of claims service, underwriting and customer support. Our insurance subsidiaries 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 insurance subsidiaries' focus on customer service, they periodically conduct policyholder service surveys to evaluate the effectiveness of their support programs, and their management meets frequently with agency personnel to seek service improvement recommendations, react to service issues and better understand local market conditions.

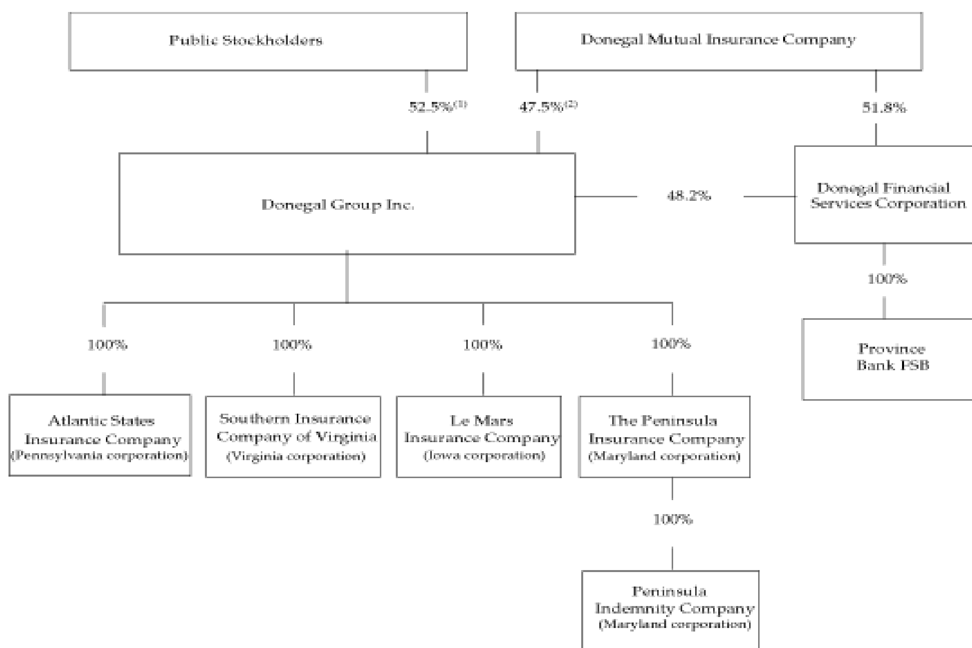
- *Maintaining premium rate adequacy to enhance the underwriting results of our insurance subsidiaries, while maintaining their existing book of business and preserving their ability to write new business.*

Our insurance subsidiaries are committed to maintaining discipline in their pricing by pursuing rate increases to maintain or improve their underwriting profitability without unduly affecting their ability to attract and retain customers. In addition to pursuing appropriate pricing, our insurance subsidiaries take numerous actions to ensure that their premium rates are adequate relative to their level of underwriting risk. Our insurance subsidiaries review loss trends on a periodic basis to identify changes in the frequency and severity of their claims and to assess the adequacy of their rates and underwriting standards. Our insurance subsidiaries also carefully monitor and audit the key information that they use to price their policies, enabling them to receive an adequate level of premiums for their risk. For example, our insurance subsidiaries inspect and perform loss control surveys on most of

the risks they insure to determine adequacy of insurance to value, assess property conditions and identify any liability exposures. Our insurance subsidiaries audit the payroll data of their workers' compensation customers to verify that the assumptions our insurance subsidiaries used to price a particular policy were accurate. By aggressively pursuing appropriate rate increases and thoroughly understanding the risks our insurance subsidiaries insure, they are able to achieve their strategy of achieving consistent underwriting profitability.

Our Organizational Structure

We have five insurance subsidiaries: Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Le Mars Insurance Company ("Le Mars") and Peninsula Insurance Group ("Peninsula"), which includes The Peninsula Insurance Company and its wholly owned subsidiary, Peninsula Indemnity Company. We also own 48.2% 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. Donegal Mutual owns the remaining 51.8% of DFSC. While not material to our operations, we believe Province Bank, with total assets of $85.1 million at December 31, 2006, will complement the product offerings of our insurance subsidiaries. The following chart depicts our organizational structure, including our insurance 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 37.6% of the aggregate voting power of both classes of our common stock.

(2) Because of the different relative voting power of our Class A common stock and our Class B common stock, Donegal Mutual holds approximately 62.4% of the aggregate voting power of both classes of our common stock.

In the mid-1980's, Donegal Mutual, like a number of other mutual property and casualty insurance companies, recognized the need to develop additional sources of capital and surplus to remain competitive, have the capacity to expand its business and assure its long-term viability. Donegal Mutual, again like a number of other mutual property and casualty insurance companies, determined to implement a downstream holding company structure as a strategic response. Thus, in 1986, Donegal Mutual formed us as a downstream holding company, initially wholly owned by Donegal Mutual, and caused us to form an insurance company subsidiary known as Atlantic States.

As part of the implementation of this strategy, Donegal Mutual and Atlantic States entered into a pooling agreement in 1986, whereby Donegal Mutual and Atlantic States each ceded all of its direct written business to the pool and the pool then allocated a portion of the pooled business back to Donegal Mutual and Atlantic States. The consideration to Donegal Mutual for entering into the pooling agreement was its ownership of majority control of us and the expectation that Donegal Mutual's surplus would increase over time as the value of its ownership interest in us increased.

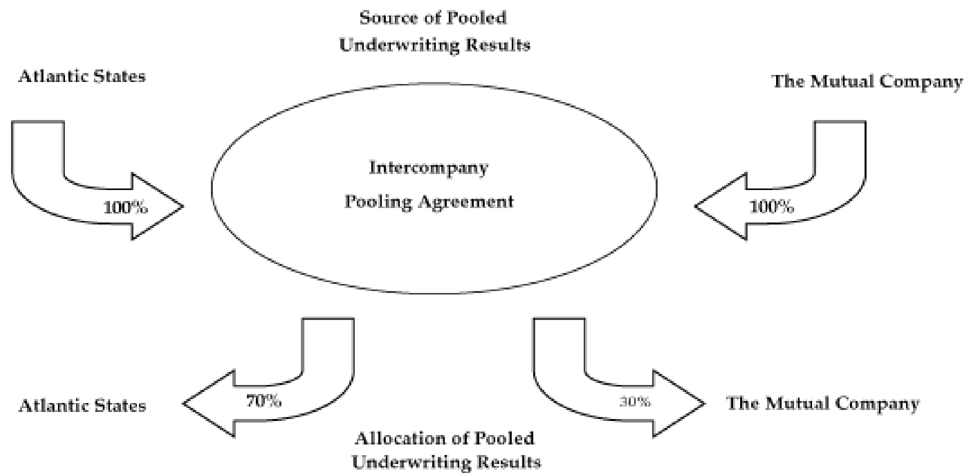
Since 1986, we have effected three public offerings, a major purpose of which was to provide capital for Atlantic States and our other insurance subsidiaries and to fund acquisitions. As the capital of Atlantic States increased, its underwriting capacity increased proportionately. Thus, as originally planned in the mid-1980's, Atlantic States has had the capital necessary to support the growth of its direct business as well as increases in the amount and percentage of business Atlantic States assumes from the underwriting pool with Donegal Mutual. As a result, the participation of Atlantic States in the underwriting pool has increased over the years from an initial participation of 35% in 1986 to a current 70% participation, and the size of the underwriting pool has increased substantially. We do not anticipate any changes in the pooling agreement between Atlantic States and Donegal Mutual in the foreseeable future, including any change in the percentage participation of Atlantic States in the underwriting pool.

The operations of our insurance subsidiaries are interrelated with the operations of Donegal Mutual, and, while maintaining the separate corporate existence of each company, Donegal Mutual and our insurance subsidiaries conduct their insurance business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries have the same business philosophy, the same management, the same employees, the same facilities and offer the same types of insurance products.

The risk profiles of the business written by our insurance subsidiaries and Donegal Mutual have historically been, and continue to be, substantially similar. The products,

classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries are determined and administered by the same management and underwriting personnel. In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a business plan to achieve market penetration and underwriting profitability objectives. The products offered by Donegal Mutual and our insurance subsidiaries are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by each of the companies will vary. However, as the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the underwriting pool, each of Donegal Mutual and Atlantic States shares the underwriting results in proportion to its participation in the pool. Atlantic States realizes 70% of the underwriting profitability of the underwriting pool because of its 70% participation in the underwriting pool. The business Atlantic States derives from the underwriting pool represents the predominant percentage of its total revenues.

The following chart depicts our underwriting pool:



Donegal Mutual provides facilities, personnel and other services to us and three of our five insurance subsidiaries, Atlantic States, Southern and Le Mars. Donegal Mutual allocates expenses to Southern and Le Mars according to a time allocation and estimated usage agreement and to Atlantic States in relation to the relative participation of Donegal Mutual

and Atlantic States in the underwriting pool. Southern and Le Mars reimburse Donegal Mutual for their personnel costs, and Southern bears its proportionate share of information services costs based on its percentage of total written premiums of the Donegal Insurance Group. Donegal Mutual allocated expenses to us and our insurance subsidiaries under such agreements of $48.8 million in 2006.

We and Donegal Mutual have maintained a coordinating committee since our formation in 1986. The coordinating committee consists of two members of our board of directors who are not also members of Donegal Mutual's board of directors and two members of Donegal Mutual's board of directors who are not also members of our board of directors.

Under our by-laws and the by-laws of Donegal Mutual, any new agreement between Donegal Mutual and us and any proposed change to an existing agreement between Donegal Mutual and us must first be submitted for approval by the coordinating committee. In determining whether or not to approve a new agreement or a change in an existing agreement, our members of the coordinating committee will not grant approval unless they both believe that the new agreement or the change in an existing agreement is fair and equitable to us and in the best interests of our stockholders, and Donegal Mutual's members of the coordinating committee will not grant approval unless they both believe that the new agreement or change in an existing agreement is fair and equitable to Donegal Mutual and its policyholders. If approved by the coordinating committee, the new agreement or change in an existing agreement will then be submitted to our board of directors and the board of directors of Donegal Mutual for their separate consideration. If the new agreement or the change in an existing agreement is not approved by both our board of directors and Donegal Mutual's board of directors, the new agreement or the change in any existing agreement will not become effective.

The coordinating committee also annually meets to review each existing agreement between Donegal Mutual and us and our insurance subsidiaries to determine if the terms of the existing agreements remain fair and equitable to us and our stockholders and fair and equitable to Donegal Mutual and its policyholders or if adjustments should be made.

Our members on the coordinating committee are Robert S. Bolinger and John J. Lyons. Donegal Mutual's members on the coordinating committee are John E. Hiestand and Frederick W. Dreher. Reference is made to our proxy statement for our annual meeting of stockholders on April 19, 2007 for information on the members of the coordinating committee.

We believe our relationship with Donegal Mutual offers us and our insurance subsidiaries a number of competitive advantages, including the following:

- Facilitating the stable management, consistent underwriting discipline, external growth and long-term profitability of our insurance subsidiaries;
- Creating operational and expense synergies given the combined resources and operating efficiencies of Donegal Mutual, us and our insurance subsidiaries;
- Enhancing our opportunities to expand by acquisition because of the ability of Donegal Mutual to affiliate with and acquire control of other mutual insurance companies and thereafter demutualize them and sell them to us;
- Producing a more uniform and stable underwriting result than our insurance subsidiaries could achieve without the relationship between Donegal Mutual and our insurance subsidiaries over extended periods of time; and
- Providing Atlantic States with a significantly larger underwriting capacity because of the underwriting pool Donegal Mutual and Atlantic States have maintained since 1986.

Acquisitions

The following table highlights our acquisition history since 1988:

Company Acquired	State of Domicile	Year Control Acquired	Method of Acquisition
Southern Mutual Insurance Company and now Southern Insurance Company of Virginia	Virginia	1984	Surplus note investment by Donegal Mutual in 1984; demutualization in 1988; acquisition of stock by us in 1988.
Pioneer Mutual Insurance Company and formerly Pioneer Insurance Company (1)	Ohio	1992	Surplus note investment by Donegal Mutual in 1992; demutualization in 1993; acquisition of stock by us in 1997.
Delaware Mutual Insurance Company and formerly Delaware Atlantic Insurance Company (1)	Delaware	1993	Surplus note investment by Donegal Mutual in 1993; demutualization in 1994; acquisition of stock by us in 1995.

Company Acquired	State of Domicile	Year Control Acquired	Method of Acquisition
Pioneer Mutual Insurance Company and formerly Pioneer Insurance Company (1)	New York	1995	Surplus note investment by Donegal Mutual in 1995; demutualization in 1998; acquisition of stock by us in 2001.
Southern Heritage Insurance Company (1)	Georgia	1998	Purchase of stock by us in 1998.
Le Mars Mutual Insurance Company of Iowa and now Le Mars Insurance Company	Iowa	2002	Surplus note investment by Donegal Mutual in 2002; demutualization in 2004; acquisition of stock by us in 2004.
Peninsula Insurance Group	Maryland	2004	Purchase of stock by us in 2004.

(1) To reduce administrative and compliance costs and expenses, the designated insurance subsidiaries 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.

As previously noted, Donegal Mutual is seeking approval of the Office of the Commissioner of Insurance of the State of Wisconsin to establish an affiliation with Sheboygan Falls. If the affiliation receives required regulatory approvals, Donegal Mutual would commence writing business in Wisconsin.

Distribution

The products of our insurance subsidiaries are marketed primarily in the Mid-Atlantic, Midwest and Southeast regions through approximately 2,000 independent insurance agencies. At December 31, 2006, the Donegal Insurance Group was actively writing business in 18 states (Alabama, Delaware, Georgia, Iowa, Louisiana, Maryland, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia and West Virginia). We believe the relationships of our insurance subsidiaries with their independent agents are valuable in identifying, obtaining and retaining profitable business. Our insurance subsidiaries maintain a stringent agency selection procedure that emphasizes appointing agencies with proven

marketing strategies for the development of profitable business, and our insurance subsidiaries appoint only agencies with a strong underwriting and growth track record. Our insurance subsidiaries also regularly evaluate their agencies based on their profitability and performance in relation to the objectives of our insurance subsidiaries. Our insurance subsidiaries seek to be among the top three insurers within each of their agencies for the lines of business they write.

The following table sets forth the percentage of direct premiums written by our insurance subsidiaries in each of the states where they conducted business in 2006:

State	%
Pennsylvania	46.5%
Maryland	13.1
Virginia	11.8
Georgia	6.0
Delaware	5.8
Ohio	3.5
Iowa	2.9
North Carolina	2.4
Tennessee	1.8
Oklahoma	1.4
Nebraska	1.2
South Dakota	1.1
Other	2.5
Total	100.0%

We believe our insurance subsidiaries have developed a number of policies and procedures that enable them to attract, retain and motivate their agents. The consistency, competitiveness and stability of the product offerings of our insurance subsidiaries assists them in competing effectively for agents with other insurers whose product offerings may fluctuate based upon industry conditions. Our insurance subsidiaries have 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 our insurance subsidiaries receive from that agency. Our insurance subsidiaries provide their agents ongoing support that enables them to better attract and retain customers, including Internet-based information systems, training programs, marketing support and field visitations from marketing personnel and senior management of our insurance subsidiaries. Finally, our insurance subsidiaries encourage their independent agents to focus on “account selling,” or serving all of a particular insured’s property and casualty insurance needs, which our insurance subsidiaries believe generally results in more favorable loss experience than covering a single risk for an individual insured.

Products

The personal lines written by our insurance subsidiaries consist primarily of automobile and homeowners insurance. The commercial lines written by our insurance subsidiaries 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 by our insurance subsidiaries for the periods indicated:

(dollars in thousands)	Year Ended December 31,					
	2004		2005		2006	
	Amount	%	Amount	%	Amount	%
Net Premiums Written:						
Personal lines:						
Automobile	$ 118,734	41.9%	$ 122,059	40.4%	$ 126,211	41.1%
Homeowners	47,540	16.8	52,149	17.2	56,005	18.2
Other	9,882	3.5	10,620	3.5	10,764	3.5
Total personal lines	176,156	62.2	184,828	61.1	192,980	62.8

(dollars in thousands)	Year Ended December 31, 2004 Amount	2004 %	2005 Amount	2005 %	2006 Amount	2006 %
Commercial lines:						
Automobile	32,679	11.5	34,641	11.4	33,387	10.9
Workers' compensation	29,228	10.3	33,154	11.0	32,845	10.7
Commercial multi-peril	42,253	14.9	46,406	15.3	44,750	14.6
Other	2,966	1.1	3,515	1.2	3,445	1.0
Total commercial lines	107,126	37.8	117,716	38.9	114,427	37.2
Total business	$ 283,282	100.0%	$ 302,544	100.0%	$ 307,407	100%

Underwriting

The personal lines underwriting and commercial lines underwriting departments of our insurance subsidiaries evaluate and select those risks that they believe will enable our insurance subsidiaries to achieve an underwriting profit. The underwriting departments have significant interaction with the independent agents regarding the underwriting philosophy and underwriting guidelines of our insurance subsidiaries and assist the 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, our insurance subsidiaries:

- 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.

Our insurance subsidiaries also review their existing policies and accounts to determine whether those risks continue to meet their underwriting guidelines. If a given policy or account no longer meets those underwriting guidelines, our insurance subsidiaries 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 the effort of our insurance subsidiaries to maintain acceptable underwriting results, they conduct annual reviews of agencies that have failed to meet their underwriting profitability criteria. The 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 the underwriting guidelines and service standards of our insurance subsidiaries. Based on the results of this review process, the marketing and underwriting personnel of our insurance subsidiaries develop, together with the agency, a plan to improve its underwriting profitability. Our insurance subsidiaries monitor the agency's compliance

with the plan, and take other measures as required in the judgment of our insurance subsidiaries, 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 the philosophy of our insurance subsidiaries to achieve underwriting profitability on a consistent basis and is fundamental to the successful operations of our insurance subsidiaries and their dedication to excellent service.

The claims departments of our insurance subsidiaries rigorously manage 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 the personnel of our insurance subsidiaries, who have significant experience in the property and casualty insurance industry and know the service philosophy of our insurance subsidiaries. Our insurance subsidiaries 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. Our insurance subsidiaries strive to respond to notifications of claims promptly, generally within the day reported. Our insurance subsidiaries believe that by responding promptly to claims, our insurance subsidiaries provide quality customer service and minimize the ultimate cost of the claims. Our insurance subsidiaries engage independent adjusters as needed to handle claims in areas in which the volume of claims is not sufficient to justify the hiring of internal claims adjusters. Our insurance subsidiaries also employ private investigators, structural experts and various outside legal counsel to supplement our in-house staff and assist in the investigation of claims. Our insurance subsidiaries 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.

The management of the claims departments of our insurance subsidiaries develops and implements policies and procedures for the establishment of adequate claim reserves. The actuarial staff employed by our insurance subsidiaries regularly reviews their reserves for incurred but not reported claims. The management and staff of the claims departments resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters. The litigation and personal injury sections of our insurance subsidiaries manage all claims litigation, and branch office claims above certain thresholds 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.

The field office staff of our insurance subsidiaries receives support from home office technical, litigation, material damage, subrogation and medical audit personnel.

Liabilities for Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of the amounts an insurer expects to pay with respect to policyholder claims based on facts and circumstances then known. An insurer recognizes at the time of establishing its estimates that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. The estimates of liabilities for losses and loss expenses of our insurance subsidiaries are based on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and consequently it often becomes necessary to refine and adjust their prior estimates of their liabilities. Our insurance subsidiaries reflect any adjustments to their liabilities for losses and loss expenses in their operating results in the period in which the changes in estimates are made.

Our insurance subsidiaries maintain liabilities for the 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. Our insurance subsidiaries 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. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends, and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses.

Reserve estimates can change over time because of unexpected changes in assumptions related to the external business environment and, to a lesser extent, assumptions as to the internal operations of our insurance subsidiaries. Assumptions related to the external business environment include the absence of significant changes in tort law and legal decisions that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions, stability in economic conditions and the rate of loss cost inflation. For example, our insurance subsidiaries have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and

characteristics of business written within a given line of business. To the extent our insurance subsidiaries determine that underlying factors impacting these assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, the ultimate liability for unpaid losses and loss expenses of our insurance subsidiaries will likely differ from the amount recorded at December 31, 2006. For every 1% change in the loss and loss expense reserves estimates of our insurance subsidiaries, net of reinsurance recoverable, the effect on the pre-tax results of operations of our insurance subsidiaries would be approximately $1.6 million.

The establishment of appropriate liabilities is an inherently uncertain process, and the ultimate liability of our insurance subsidiaries could exceed their loss and loss expense reserves and have an adverse effect on their results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to the estimated future liabilities of our insurance subsidiaries cannot be predicted, since the historical conditions and events that serve as a basis for the estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods their estimates have exceeded their actual liabilities. Changes in estimates of the liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. Our insurance subsidiaries recognized a decrease in their liability for losses and loss expenses of prior years of $13.6 million, $9.4 million and $7.2 million in 2006, 2005 and 2004, respectively. Generally, our insurance subsidiaries experienced improving loss development trends in 2006, 2005 and 2004, which were reflected in favorable settlements of open claims by our insurance subsidiaries. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management, and there have been no significant offsetting changes in estimates that increased or decreased the loss and loss expense reserves in these periods. The 2006 development was primarily recognized in the private passenger automobile liability, workers’ compensation and commercial multi-peril lines of business and was consistently favorable for settlements of claims occurring in each of the previous five accident years. The majority of the 2006 development was related to decreases in the liability for losses and loss expenses of prior years for Atlantic States.

Excluding the impact of isolated catastrophic weather events, our insurance subsidiaries have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic conditions extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims. Further adjustments to the estimates of our

insurance subsidiaries could be required in the future. However, on the basis of the internal procedures, including review by the actuaries for our insurance subsidiaries, which analyze, among other things, the prior assumptions of our insurance subsidiaries, the experience of our insurance subsidiaries 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, our insurance subsidiaries believe that they have made adequate provision for their liability for losses and loss expenses as of December 31, 2006.

Because of the participation of Atlantic States in the underwriting pool with Donegal Mutual, Atlantic States is exposed to adverse loss development on the business of Donegal Mutual that is included in the underwriting pool. However, pooled business represents the predominant percentage of the net underwriting activity of Donegal Mutual and Atlantic States, and Donegal Mutual and Atlantic States proportionately share any adverse risk development of the pooled business. The business in the pool is homogenous (i.e., Atlantic States has a 70% share of the entire pool and Donegal Mutual has a 30% share of the entire pool). Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results are shared by each company according to its participation level under the terms of the pooling agreement, the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for Donegal Mutual and Atlantic States than they would experience individually and to spread the risk of loss among Donegal Mutual and Atlantic States.

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 $8.1 million, $8.3 million and $8.1 million at December 31, 2004, 2005 and 2006, respectively.

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

(in thousands)	Year Ended December 31, 2004	2005	2006
Gross liability for unpaid losses and loss expenses at beginning of year	$217,914	$267,190	$265,730
Less reinsurance recoverable	79,018	95,759	92,721
Net liability for unpaid losses and loss expenses at beginning of year	138,896	171,431	173,009
Acquisitions of Le Mars and Peninsula	28,843	—	—
Beginning balance as adjusted	167,739	171,431	173,009
Provision for net losses and loss expenses for claims incurred in the current year	171,385	176,924	182,037
Change in provision for estimated net losses and loss expenses for claims incurred in prior years	(7,243)	(9,382)	(13,616)
Total incurred	164,142	167,542	168,421
Net losses and loss payments for claims incurred during:			
The current year	96,041	98,735	106,401
Prior years	64,409	67,229	71,717
Total paid	160,450	165,964	178,118
Net liability for unpaid losses and loss expenses at end of year	171,431	173,009	163,312
Plus reinsurance recoverable	95,759	92,721	95,710
Gross liability for unpaid losses and loss expenses at end of year	$267,190	$265,730	$259,022

The following table sets forth the development of the liability for net unpaid losses and loss expenses of our insurance subsidiaries from 1996 to 2006, with supplemental loss data for 2005 and 2006. Loss data in the table includes business ceded to Atlantic States from the underwriting pool.

"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 increases or decreases as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 2002 liability has developed a redundancy after four years, in that reestimated net losses and loss expenses are expected to be $11.3 million less than the estimated liability initially established in 2002 of $131.1 million.

The “Cumulative (excess) deficiency” shows the cumulative excess or deficiency at December 31, 2006 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 our insurance subsidiaries reevaluated the liability 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 our insurance subsidiaries reevaluated the liability 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 2002 column indicates that as of December 31, 2006 payments equal to $105.1 million of the currently reestimated ultimate liability for net losses and loss expenses of $119.8 million had been made.

Amounts shown in the 2004 column of the table include information for Le Mars and Peninsula for all accident years prior to 2004.

(in thousands)	Year Ended December 31, 1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Net liability at end of year for unpaid losses and loss expenses	$ 78,889	$ 80,256	$ 96,015	$ 99,234	$ 102,709	$ 114,544	$ 131,108	$ 138,896	$ 171,431	$ 173,009	$ 163,312
Net liability reestimated as of:											
One year later	77,400	77,459	95,556	100,076	110,744	121,378	130,658	136,434	162,049	159,393	
Two years later	73,438	76,613	95,315	103,943	112,140	120,548	128,562	130,030	152,292		
Three years later	71,816	74,851	94,830	104,073	110,673	118,263	124,707	123,399			
Four years later	69,378	73,456	94,354	101,880	108,766	114,885	119,817				
Five years later	69,485	73,103	93,258	100,715	107,561	113,070					
Six years later	69,949	72,706	92,818	100,479	106,950						
Seven years later	69,415	72,319	92,400	99,968							
Eight years later	69,279	72,421	92,064								
Nine years later	69,310	72,344									
Ten years later	69,233										
Cumulative (excess) deficiency	$ (9,656)	$ (7,912)	$ (3,951)	$ 734	$ 4,241	$ (1,474)	$ (11,291)	$ (15,497)	$ (19,139)	$ (13,616)	
Cumulative amount of liability paid through:											
One year later	$ 27,229	$ 27,803	$ 37,427	$ 39,060	$ 43,053	$ 45,048	$ 46,268	$ 51,965	$ 67,229	$ 71,718	
Two years later	41,532	46,954	57,347	60,622	67,689	70,077	74,693	81,183	102,658		
Three years later	53,555	58,883	69,973	76,811	82,268	87,198	93,288	99,910			
Four years later	59,995	65,898	78,757	85,453	92,127	97,450	105,143				
Five years later	63,048	70,642	83,038	91,337	98,007	104,551					
Six years later	65,595	72,801	85,935	94,420	101,664						
Seven years later	66,976	74,444	87,600	96,823							
Eight years later	67,974	75,372	89,320								
Nine years later	68,596	76,326									
Ten years later	69,415										

	Year Ended December 31 1998	1999	2000	2001	2002	2003	2004	2005	2006
					(in thousands)				
Gross liability at end of year	$136,727	$144,180	$156,476	$179,840	$210,692	$217,914	$267,190	$265,730	$259,022
Reinsurance recoverable	40,712	44,946	53,767	65,296	79,584	79,018	95,759	92,721	95,710
Net liability at end of year	96,015	99,234	102,709	114,544	131,108	138,896	171,431	173,009	163,312
Gross reestimated liability – latest	130,027	156,925	173,297	190,996	208,444	211,299	243,951	243,238	
Reestimated recoverable – latest	37,963	56,957	66,347	77,926	88,627	87,900	91,659	83,845	
Net reestimated liability – latest	92,064	99,968	106,950	113,070	119,817	123,399	152,292	159,393	
Gross cumulative deficiency (excess)	(6,700)	12,745	16,821	11,156	(2,248)	(6,615)	(23,239)	(22,492)	

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Technology

Donegal Mutual owns the majority of the technology systems our insurance subsidiaries use. The technology systems consist primarily of an integrated central processing computer, a series of server-based computer networks and various communications systems that allow the home office of our insurance subsidiaries and their branch offices to utilize the same systems for the processing of business. Donegal Mutual maintains backup facilities and systems through a contract with a leading provider of computer disaster recovery sites, and tests these backup facilities and systems on a regular basis. Atlantic States and Southern bear their proportionate share of information services expenses based on their proportionate percentages of the total net written premiums of the Donegal Insurance Group. Le Mars and Peninsula use separate technology systems that perform similar functions.

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

We believe the availability and use of these technology systems has resulted in improved service to agents and customers and increased efficiencies in processing the business of our insurance subsidiaries and resulted in lower operating costs. Three key components of these integrated technology systems are the agency interface system, the WritePro® and WriteBiz® systems and an imaging system. The agency interface system provides our insurance subsidiaries with a high level of data sharing both to, and from, agents' systems and also provides agents with an integrated means of processing new business. The WritePro® and WriteBiz® systems are fully automated underwriting and policy issuance systems that provide agents with the ability to generate underwritten quotes and automatically issue policies that meet the underwriting guidelines of our insurance subsidiaries with limited or no intervention by their personnel. The imaging system reduces the need to handle paper files, while providing greater access to the same information by a variety of personnel.

Third Party Reinsurance

Atlantic States, Southern and Donegal Mutual purchase reinsurance on a combined basis. Le Mars and Peninsula have separate reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with the requirements of our insurance subsidiaries, 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 Atlantic States, Southern and Donegal Mutual purchase includes:

- “excess of loss reinsurance,” under which losses are automatically reinsured, through a series of contracts, over a set retention ($400,000 for 2006), and
- “catastrophic reinsurance,” under which our insurance subsidiaries recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters ($3.0 million retention for 2006).

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.

The principal third party reinsurance agreement of our insurance subsidiaries in 2006 was a multi-line per risk excess of loss treaty with Partner Reinsurance Company, Dorinco Reinsurance Company, Hannover Ruckversicherungs-AG, QBE Reinsurance Corporation and XL Reinsurance America, Inc. that provides 100% coverage up to $1.0 million for both property and liability losses.

For property insurance, in 2006 our insurance subsidiaries also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $2.5 million per occurrence. For liability insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $40.0 million per occurrence. For workers’ compensation insurance in 2006, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $5.0 million on any one life.

Our insurance subsidiaries have property catastrophe coverage through a series of layered treaties up to aggregate losses of $80.0 million for Atlantic States, Southern and Donegal Mutual for any single event. This coverage is provided through as many as 26 reinsurers on any one treaty with no reinsurer taking more than 22.5% of the exposure under any one treaty.

Our insurance subsidiaries purchase facultative reinsurance to cover exposures from property and casualty losses that exceed the limits provided by their respective treaty reinsurance.

Competition

The property and casualty insurance industry is highly competitive on the basis of both price and service. Numerous companies compete for business in the geographic areas

where our insurance subsidiaries operate, many of which are substantially larger and have greater financial resources than those of our insurance subsidiaries. In addition, because the insurance products of our insurance subsidiaries and those of Donegal Mutual are marketed exclusively through independent insurance agencies, most of which represent more than one insurance company, our insurance subsidiaries face competition within agencies as well as competition to retain qualified independent agents.

Investments

Return on invested assets is an important element of the financial results of our insurance subsidiaries, and the investment strategy of our insurance subsidiaries is to generate an appropriate amount of after-tax income on invested assets while minimizing credit risk through investments in high-quality securities. As a result, our insurance subsidiaries seek to invest a high percentage of their assets in a diversified, highly rated and readily marketable group of fixed-maturity instruments. Their fixed-maturity portfolios consist of both taxable and tax-exempt securities. Our insurance subsidiaries maintain a portion of their portfolios in short-term securities, such as investments in commercial paper, to provide liquidity for the payment of claims and operation of their businesses. Our insurance subsidiaries maintain a small percentage (7% at December 31, 2006) of their portfolios in equity securities.

At December 31, 2006, all debt securities held by our insurance subsidiaries had an investment-grade rating with the exception of a $250,000 unrated obligation. The investment portfolios of our insurance subsidiaries did not contain any mortgage loans or any non-performing assets at December 31, 2006.

The following table shows the composition of the debt securities (at carrying value) in the investment portfolios of our insurance subsidiaries, excluding short-term investments, by rating as of December 31, 2006:

(dollars in thousands) Rating(1)	December 31, 2006 Amount	 Percent
U.S. Treasury and U.S. agency securities(2)	$ 168,933	33.7%
Aaa or AAA	268,188	53.6
Aa or AA	48,274	9.6
A	10,113	2.0
BBB	5,090	1.0
Not rated(3)	250	0.1
Total	$ 500,848	100.0%

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

(2) Includes mortgage-backed securities of $66,003,426.

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

Our insurance subsidiaries invest in both taxable and tax-exempt securities as part of their strategy to maximize after-tax income, and are currently increasing their investments in tax-exempt securities. This strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 46.2%, 55.8% and 59.7% of the debt securities in the investment portfolios of our insurance subsidiaries at December 31, 2004, 2005 and 2006, respectively.

The following table shows the classification of the investments of our insurance subsidiaries (at carrying value) at December 31, 2004, 2005 and 2006:

	December 31,					
	2004		2005		2006	
(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	$ 60,219	12.1%	$ 58,735	10.7%	$ 58,094	9.8%
Obligations of states and political subdivisions	76,652	15.4	84,656	15.5	83,283	14.1
Corporate securities	27,149	5.4	21,509	3.9	14,638	2.5
Mortgage-backed securities	18,554	3.7	15,282	2.8	13,163	2.2
Total held to maturity	182,574	36.6	180,182	32.9	169,178	28.6
Available for sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	74,917	15.0	50,859	9.3	44,836	7.6
Obligations of states and political subdivisions	112,446	22.5	180,571	33.0	215,518	36.5
Corporate securities	31,352	6.3	20,112	3.7	18,476	3.1
Mortgage-backed securities	8,042	1.6	43,555	7.9	52,840	8.9
Total available for sale	226,757	45.4	295,097	53.9	331,670	56.1
Total fixed maturities	409,331	82.0	475,279	86.8	500,848	84.7
Equity securities(2)	33,505	6.7	33,371	6.1	40,542	6.9
Investments in affiliates(3)	8,865	1.8	8,442	1.5	8,463	1.4
Short-term investments(4)	47,368	9.5	30,654	5.6	41,485	7.0
Total investments	$ 499,069	100.0%	$ 547,746	100.0%	$ 591,338	100.0%

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(1) Our insurance subsidiaries account for their 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 5 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 $184.7 million at December 31, 2004, $178.6 million at December 31, 2005 and $168.4 million at December 31, 2006. The amortized cost of fixed maturities classified as available for sale was $222.1 million at December 31, 2004, $295.1 million at December 31, 2005 and $330.4 million at December 31, 2006.

(2) Equity securities are valued at fair value. Total cost of equity securities was $30.8 million at December 31, 2004, $29.0 million at December 31, 2005 and $33.5 million at December 31, 2006.

(3) Investments in affiliates are valued at cost, adjusted for our share of earnings and losses of our affiliates as well as changes in equity of our affiliates due to unrealized gains and losses.

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

The following table sets forth the maturities (at carrying value) in fixed maturity and short-term investment portfolios of our insurance subsidiaries at December 31, 2004, December 31, 2005 and December 31, 2006:

	December 31,					
	2004		2005		2006	
(dollars in thousands)	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Due in(1):						
One year or less	$ 61,837	13.5%	$ 55,717	11.0%	$ 72,966	13.5%
Over one year through three years	67,440	14.8	60,852	12.0	68,468	12.6
Over three years through five years	88,910	19.5	59,006	11.7	43,453	8.0
Over five years through ten years	74,853	16.4	136,344	26.9	171,579	31.6
Over ten years through fifteen years	131,669	28.8	131,355	26.0	113,714	20.9
Over fifteen years	5,395	1.2	3,821	0.8	6,150	1.2
Mortgage-backed securities	26,596	5.8	58,838	11.6	66,003	12.2
	$456,700	100.0%	$505,933	100.0%	$542,333	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, our insurance subsidiaries held investments in mortgage-backed securities having a carrying value of $66.0 million at December 31, 2006. The mortgage-backed securities consist primarily of investments in governmental agency balloon pools with stated maturities between two and 25 years. The stated maturities of these investments limit the exposure of our insurance subsidiaries to extension risk should interest rates rise and prepayments decline. Our insurance subsidiaries perform an analysis of the underlying loans when evaluating a mortgage-backed security for purchase, and they select those securities that they believe will provide a return that properly reflects the prepayment risk associated with the underlying loans.

The investment results of our insurance subsidiaries for the years ended December 31, 2004, 2005 and 2006 are shown in the following table:

(dollars in thousands)	Year Ended December 31, 2004	2005	2006
Invested assets(1)	$460,173	$523,408	$569,542
Investment income(2)	15,907	18,472	21,320
Average yield	3.5%	3.5%	3.7%

(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 our insurance subsidiaries and Donegal Mutual is A (Excellent), based upon their respective current financial condition and historical statutory results of operations and retrocessional agreements. We believe that the A.M. Best rating of Donegal Mutual and our insurance subsidiaries is an important factor in their marketing of their products to their 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. 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 the payment of claims of policyholders and are not directed toward the protection of investors in insurance companies. According to A.M. Best, the "Excellent" rating that Donegal Insurance Group maintains is assigned to those companies that, in A.M. Best's opinion, have an excellent ability to meet their ongoing obligations to policyholders.

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, 2006, our insurance subsidiaries and Donegal Mutual 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 Donegal Mutual 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. Our insurance subsidiaries and Donegal Mutual have made accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations.

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 Donegal Mutual 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, which generally applies to us and our insurance subsidiaries, 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 (the "Department") and is subject to Department review. The pooling agreement between Donegal Mutual and Atlantic States and the reinsurance agreements between Donegal Mutual and our insurance subsidiaries were filed with the Department.

Approval of the applicable insurance commissioner is also required prior to consummation of transactions affecting the control of an insurer. In virtually all states, including Pennsylvania, Iowa, Maryland and Virginia where our insurance subsidiaries are domiciled, 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 Department approved Donegal Mutual'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.

Our insurance subsidiaries are required to participate in involuntary insurance programs for automobile insurance, as well as other property and casualty insurance lines, in states in which they operate. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements (FAIR) plans, reinsurance facilities, windstorm and tornado 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, 2006, the amount of dividends our insurance subsidiaries could pay us during 2007, without the prior approval of the various insurance commissioners, was:

Name of Insurance Subsidiary	Ordinary Dividend Amount
Atlantic States Insurance Company	$ 26.7 million
Southern Insurance Company of Virginia	5.9 million
Le Mars Insurance Company	2.5 million
Peninsula Insurance Group	3.3 million

Donegal Mutual

Donegal Mutual was organized in 1889. At December 31, 2006, Donegal Mutual had admitted assets of $296.5 million and policyholders' surplus of $136.1 million. At

December 31, 2006, Donegal Mutual had debt of $5.0 million and, of its total liabilities of $160.4 million, reserves for net losses and loss expenses accounted for $58.9 million and unearned premiums accounted for $40.8 million. Of Donegal Mutual's investment portfolio of $216.0 million at December 31, 2006, investment-grade bonds accounted for $54.8 million and mortgages accounted for $3.7 million. At December 31, 2006, Donegal Mutual owned 8,132,884 shares, or approximately 41%, of our Class A common stock, which were carried on Donegal Mutual's books at $93.1 million, and 3,851,226 shares, or approximately 69%, of our Class B common stock, which were carried on Donegal Mutual's books at $44.1 million. The foregoing financial information is presented on the statutory basis of accounting required by the NAIC Accounting Practices and Procedures Manual. Donegal Mutual does not, nor is it required to, prepare financial statements in accordance with GAAP.

Donegal Financial Services Corporation

Because of our and Donegal Mutual's ownership of DFSC, both we and Donegal Mutual are regulated as unitary savings and loan holding companies. As such, we and Donegal Mutual 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 banks, 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 Donegal Mutual.

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 2006 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.

Available Information

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and our other filings pursuant to the Securities Exchange Act of 1934, or Exchange Act, are available without charge on our website, www.donegalgroup.com, as soon as reasonably practicable after they are filed electronically with the Securities and Exchange Commission, or 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 annual report.

Item 1A. Risk Factors.

Risk Factors

Risks Relating to Us and Our Business

Donegal Mutual is our controlling stockholder, and it and its directors and executive officers must resolve potential conflicts of interest between the best interests of our stockholders and the best interests of the policyholders of Donegal Mutual.

Donegal Mutual controls the election of all of the members of our board of directors. Four of the nine members of our board of directors are also directors of Donegal Mutual. We and Donegal Mutual have the same executive officers. These common directors and executive officers have a fiduciary duty to our stockholders and also have a fiduciary duty to the policyholders of Donegal Mutual. Among the potential conflicts of interest that arise from these separate fiduciary duties are:

- We and Donegal Mutual periodically review the percentage participation of Atlantic States and Donegal Mutual in an underwriting pool that they have maintained since 1986;
- Our insurance subsidiaries and Donegal Mutual must annually establish the terms of certain reinsurance agreements between them;
- We and Donegal Mutual must periodically allocate certain shared expenses among Donegal Mutual, us and our insurance subsidiaries in accordance with various inter-company expense-sharing agreements; and
- Our insurance subsidiaries may enter into other transactions or contractual relationships with Donegal Mutual.

Donegal Mutual has the power to determine the outcome of all matters submitted to our stockholders for approval.

Each share of our Class A common stock is entitled to one-tenth of a vote per share and generally can vote as a separate class only on matters that would affect the rights of holders of our Class A common stock. Donegal Mutual has the right to vote approximately 62.4% of the aggregate voting power of our Class A common stock and our Class B common stock, and has sufficient voting control to:

- elect all of the members of our board of directors, who determine our management and policies; and
- control the outcome of any corporate transaction or other matter submitted to our stockholders for approval, including mergers or other acquisition proposals and the sale of all or substantially all of our assets.

The interests of Donegal Mutual in maintaining its majority control of us may have an adverse effect on the price of our Class A common stock and our Class B common stock because of the absence of any potential "takeover" premium and may be inconsistent with the interests of our stockholders other than Donegal Mutual.

Donegal Mutual's voting control of us, certain provisions of our certificate of incorporation and by-laws and certain provisions of Delaware law make it unlikely that anyone could acquire control of us unless Donegal Mutual were in favor of the change of control.

Donegal Mutual's voting control of us, certain anti-takeover provisions in our certificate of incorporation and by-laws and certain provisions of the Delaware General Corporation Law, or DGCL, could delay or prevent the removal of members of our board of directors and could make more difficult or more expensive a merger, tender offer or proxy contest involving us to succeed, even if such events were in the best interests of our

stockholders other than Donegal Mutual. These factors could also discourage a third party from attempting to acquire control of us. In particular, our certificate of incorporation and by-laws include the following anti-takeover provisions:

- our board of directors is classified into three classes, so that stockholders elect only one-third of the members of our board of directors each year;
- stockholders may remove our directors only for cause;
- stockholders may not take action except at an annual or special meeting of stockholders;
- the request of stockholders holding at least 20% of the voting power of our Class A common stock and our Class B common stock is required to call a special meeting of stockholders;
- stockholders are required to provide advance notice to us to nominate candidates for election to our board of directors or to make a stockholder proposal at a stockholders' meeting;
- cumulative voting rights are not available in the election of directors;
- pre-emptive rights are not available in connection with the issuance of securities by us; and
- our board of directors is permitted to issue, without stockholder approval unless otherwise required by law, preferred stock with such terms as our board of directors may determine.

Moreover, the DGCL contains certain provisions that prohibit certain business combination transactions with an interested stockholder under certain circumstances.

We have authorized preferred stock that we could issue to make it more difficult for a third party to acquire us.

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.

Because we are an insurance holding company, no person can acquire a 10% or greater interest in us without first obtaining approval of the insurance commissioners of the states of domicile of our insurance subsidiaries.

We own insurance subsidiaries that are domiciled in the states of Pennsylvania, Maryland, Virginia and Iowa. The insurance laws of each of these states provide that no person can acquire a 10% or greater interest in us without first filing specified information with the insurance commissioner of that state and obtaining the prior approval of the proposed acquisition of a 10% or greater interest in us by the state insurance commissioner based on statutory standards designed to protect the safety and soundness of the insurance subsidiary.

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

Our insurance subsidiaries conduct business in states located primarily in the Mid-Atlantic, Midwestern and Southeastern portions of the United States. A substantial portion of their business is private passenger and commercial automobile, homeowners and workers' compensation insurance in Pennsylvania, Maryland and Virginia. While our insurance subsidiaries actively manage their exposure to catastrophes through their 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 our insurance subsidiaries conduct substantial business could materially adversely affect their business, financial condition and results of operations. Common catastrophic events include hurricanes, earthquakes, tornadoes, wind and hail storms, fires, explosions and severe winter storms.

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

Our insurance subsidiaries market their insurance products solely through a network of approximately 2,000 independent insurance agencies. This agency force is one of the most important components of the competitive profile of our insurance subsidiaries. As a result, our insurance subsidiaries are materially dependent upon their independent agents, each of whom has the authority to bind our insurance subsidiaries to insurance contracts. To the extent that our independent agents' marketing efforts cannot be maintained at their current levels of volume and quality or they bind our insurance subsidiaries to unacceptable insurance risks, fail to comply with the established underwriting guidelines of our insurance subsidiaries or otherwise inappropriately market the products of our insurance subsidiaries, the business, financial condition and results of operations of our insurance subsidiaries will suffer.

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

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

- the significant competition to attract independent agents;
- the intense and time-consuming process to select a new independent agent;
- the stringent criteria of our insurance subsidiaries which require that independent agents adhere to consistent underwriting standards; and
- the ability of our insurance subsidiaries to pay competitive and attractive commissions, bonuses and other incentives to independent agents.

While our insurance subsidiaries sell insurance solely through their network of independent agencies, many competitors of our insurance subsidiaries sell insurance through a variety of delivery methods, including independent agencies, captive agencies, the Internet and direct sales. To the extent that the policyholders represented by the independent agents of our insurance subsidiaries change their delivery system preference, the business, financial condition and results of operations of our insurance subsidiaries 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 ordinary dividends that our insurance subsidiaries can pay to us in 2007 without prior regulatory approval is approximately $38.4 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 the ratings, competitive position and the amount of premiums that our insurance subsidiaries can write as well as their ability to pay future dividends.

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

Industry ratings are a factor in establishing the competitive position of insurance companies. Our insurance subsidiaries and Donegal Mutual 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 its obligations to policyholders. We believe that the financial strength rating of A.M. Best is material to the operations of Donegal Mutual and our insurance subsidiaries. Currently, Donegal Mutual and our insurance subsidiaries each have an A (Excellent) rating from A.M. Best. If Donegal Mutual or any of our insurance subsidiaries were to be downgraded by A.M. Best, it would adversely affect the competitive position of our insurance subsidiaries and make it more difficult for them to market their products and retain their 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 the organic growth of our insurance subsidiaries and make acquisitions, we may not be able to expand our business.

Our strategy is to expand our business through the organic growth of our insurance subsidiaries and through our strategic acquisitions of regional insurance companies. Our insurance subsidiaries 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 the business of our insurance subsidiaries 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 our insurance subsidiaries 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 the competitors of our insurance subsidiaries are financially stronger than our insurance subsidiaries are and these competitors may be able to offer lower-priced products our insurance subsidiaries may be unable to match.

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. Our insurance subsidiaries 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 our insurance subsidiaries, have substantially greater financial, technical and operating resources than our insurance subsidiaries and have equal or higher ratings from A.M. Best. In addition, 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 the competitors of our insurance subsidiaries 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. Our insurance subsidiaries may not be able to maintain their current competitive position in the markets in which they operate if their competitors offer prices on products that are lower than the prices our insurance subsidiaries can offer. Moreover, if these competitors lower the price of their products and our insurance subsidiaries meet their pricing, the profit margins and revenues of our insurance subsidiaries may be reduced and their ratios of claims and expenses to premiums may increase, which may materially adversely affect the financial condition and results of operations of our insurance subsidiaries.

Because the investment portfolios of our insurance subsidiaries are made up primarily of fixed-income securities, their investment income and the fair value of their investment portfolios could suffer as a result of a number of factors.

Our insurance subsidiaries invest the premiums they receive from their policyholders and maintain investment portfolios that consist primarily of fixed-income securities. The management of these investment portfolios is an important component of their profitability because a significant portion of the operating income of our insurance subsidiaries is generated from the income they receive on their invested assets. The quality and/or yield of their portfolios 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 our insurance subsidiaries own, changes in market conditions and regulatory changes. The fixed-income securities our insurance subsidiaries 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 the ability of our insurance subsidiaries to collect principal and interest from the issuer.

The investments of our insurance subsidiaries 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 fixed-rate securities. If interest rates decline, our insurance subsidiaries would generally achieve a lower overall rate of return on investments of cash generated from their operations. In addition, in the event that investments are called or mature in a declining interest rate environment, our insurance subsidiaries may be unable to reinvest the proceeds in securities with comparable interest rates. Changes in interest rates may reduce both the profitability and the return on the invested capital of our insurance subsidiaries.

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

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

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

The Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, has resulted in changes in our corporate governance, public disclosure and compliance practices. Sarbanes-Oxley also

required that the SEC promulgate new rules on a variety of corporate governance and disclosure subjects. In addition to these rules, NASDAQ has adopted revisions to its requirements for companies listed on NASDAQ, like us. These developments have resulted, and are expected to continue to result, in increased 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 our insurance subsidiaries rely do not relieve our insurance subsidiaries from liability to their policyholders, and our insurance subsidiaries face a risk of non-payment from their reinsurers and the non-availability of reinsurance in the future.

Our insurance subsidiaries rely on reinsurance agreements to limit their maximum net loss from large single risks or risks in concentrated areas, and to increase their capacity to write insurance. Although the reinsurance our insurance subsidiaries maintain provides that the reinsurer is liable to them, the reinsurance does not relieve our insurance subsidiaries from liability to their policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable to our insurance subsidiaries under the terms of its reinsurance agreement with them, our insurance subsidiaries remain liable for such losses. As of December 31, 2006, our insurance subsidiaries had approximately $41.4 million of reinsurance receivables from third-party reinsurers relating to paid and unpaid losses. The insolvency or inability of these reinsurers to make timely payments to our insurance subsidiaries under the terms of their reinsurance agreements would adversely affect their results of operations.

In addition, our insurance subsidiaries face a risk of the non-availability of reinsurance or an increase in reinsurance costs that could adversely affect their ability to write business or their results of operations. Market conditions beyond the control of our insurance subsidiaries, such as the amount of surplus in the reinsurance market and natural and man-made catastrophes, affect the availability and cost of the reinsurance our insurance subsidiaries purchase. If our insurance subsidiaries were unable to maintain their current level of reinsurance or purchase new reinsurance protection in amounts that our insurance subsidiaries consider sufficient, our insurance subsidiaries would either have to be willing to accept an increase in their net risk retention or reduce their insurance writings, and their business, financial condition and results of operations could be adversely affected.

Risks Relating to the Property and Casualty Insurance Industry

Our insurance subsidiaries 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. The personal and commercial property and casualty insurance policies of our insurance subsidiaries are not priced to cover the risk of terrorist attacks and losses such as those suffered in the World Trade Center terrorist attack. Therefore, our insurance subsidiaries have exposure to terrorism under the lines of insurance products that they offer. The Terrorism Risk Insurance Extension Act of 2005, or "TRIA," may reduce the impact of future losses as a result of terrorism in connection with commercial insurance products our insurance subsidiaries offer; however, because of the uncertainty regarding the application of TRIA, the amount of losses our insurance subsidiaries may be required to retain as a result of terrorism may result in a material adverse effect on their business, financial condition and results of operations. TRIA now has an expiration date of December 31, 2008, and will not provide coverage beyond that time unless it is extended. While TRIA includes higher retention levels for insurers in 2007, the program's expiration at the end of 2008 will result in an increase in insurers' loss retention in 2009. TRIA does not cover the personal insurance products our insurance subsidiaries offer, and state regulators have not approved exclusions for acts of terrorism in the personal insurance products offered by our insurance subsidiaries. Therefore, our insurance subsidiaries could incur large unexpected losses from the personal insurance policies that they issue, which could have a material adverse effect on their 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 the reserves of our insurance subsidiaries.

Loss severity in the property and casualty insurance 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 the loss reserves of our insurance subsidiaries inadequate for current and future losses.

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

Our insurance subsidiaries use credit scoring as a factor in making risk selection and pricing decisions where allowed by state law for personal lines 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 the future profitability of our insurance subsidiaries.

Changes in applicable insurance laws or regulations or changes in the way regulators administer those laws or regulations could materially adversely change the operating environment of our insurance subsidiaries and increase their exposure to loss or put them 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, our insurance subsidiaries are subject to involuntary participation in specified markets in various states in which they operate, and the rate levels our insurance subsidiaries are permitted to charge do not always correspond with the underlying costs associated with the coverage our insurance subsidiaries 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 the operating environment of our insurance subsidiaries and have an adverse effect on their 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 the pricing of our insurance subsidiaries, 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, the results of operations of our insurance subsidiaries 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 the automobile lines of business offered by our insurance subsidiaries in various states because increasing costs of litigation and medical treatment, combined with rising automobile repair costs, continue to increase the cost of providing automobile insurance coverage that our insurance subsidiaries may not be able to offset by increasing the rates for their automobile insurance products. Adverse legislative and regulatory activity constraining the ability of our insurance subsidiaries to price automobile insurance coverage adequately may occur in the future. The impact of the automobile insurance regulatory environment on the results of operations of our insurance subsidiaries in the future is not predictable.

Our insurance subsidiaries are subject to assessments, based on their 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 the financial condition of our insurance subsidiaries.

Our insurance subsidiaries are obligated to pay assessments under the guaranty fund laws of the various states in which they are licensed. Generally, under these laws, our insurance subsidiaries are subject to assessment, depending upon their 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 our insurance subsidiaries conduct business cannot be predicted, but future assessments could significantly affect the business, financial condition and results of operations of our insurance subsidiaries.

Our insurance subsidiaries 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 the profitability of our insurance subsidiaries could be adversely affected to the extent their 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, our insurance subsidiaries must establish premium rates from forecasts of the ultimate costs they expect to arise from risks they have underwritten during the policy period, and their premium rates may not be

adequate to cover the ultimate losses incurred. Further, our insurance subsidiaries must establish reserves for losses and loss expenses based upon estimates involving actuarial and statistical projections at a given time of what our insurance subsidiaries expect their ultimate liability to be, and it is possible that their 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 our insurance subsidiaries establish are not sufficient, their business, financial condition and results of operations may be adversely impacted.

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

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 our insurance subsidiaries find it necessary to reduce premiums or limit premium increases due to these competitive pressures on pricing, our insurance subsidiaries may experience a reduction in their profit margins and revenues, an increase in their 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, 2006 was approximately 37,000 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 26, 2007, we had outstanding 19,715,101 shares of our Class A common stock and 5,576,775 shares of our Class B common stock. Apart from

the shares held by Donegal Mutual, 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 Donegal Mutual could cause the price of our Class A common stock to fall.

Donegal Mutual'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 Donegal Mutual were in favor of the change of control.

Donegal Mutual'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, Maryland, Iowa 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 Donegal Mutual. 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 DGCL contains certain provisions that prohibit certain business combination transactions under certain circumstances. In addition, state insurance laws and regulations generally prohibit any person 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.

Item 1B. Unresolved Staff Comments.

No written comments made by the SEC staff regarding our filings under the Exchange Act remain unresolved.

Item 2. Properties.

We and our insurance subsidiaries share headquarters with Donegal Mutual in a building in Marietta, Pennsylvania owned by Donegal Mutual. Donegal Mutual charges us and our insurance subsidiaries for an appropriate portion of the building expenses under an inter-company allocation agreement. The Marietta headquarters 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,

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Iowa and Peninsula owns a facility of approximately 14,600 square feet in Salisbury, Maryland.

Item 3. Legal Proceedings.

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

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

We did not submit any matter to a vote of the holders of our Class A common stock or Class B common stock during the fourth quarter of 2006.

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 10 years:

Name	Age	Position
Donald H. Nikolaus	64	President and Chief Executive Officer of Donegal Mutual since 1981; President and Chief Executive Officer of the Company since 1986.
Robert G. Shenk	52	Senior Vice President, Claims, of Donegal Mutual and the Company since 1997; Vice President, Claims, of Donegal Mutual and the Company from 1992 to 1997 and Manager, Casualty Claims, of Donegal Mutual from 1985 to 1992 and the Company from 1986 to 1992.
Cyril J. Greenya	61	Senior Vice President and Chief Underwriting Officer, of Donegal Mutual and the Company since 2005, Senior Vice President, Underwriting of Donegal Mutual from 1997 to 2005, Vice President, Commercial Underwriting, of Donegal Mutual and the Company from 1992 to 1997 and Manager, Commercial Underwriting of Donegal Mutual from 1983 to 1992 and the Company from 1986 to 1992.

Name	Age	Position
Daniel J. Wagner	45	Senior Vice President and Treasurer of Donegal Mutual and the Company since 2005; Vice President and Treasurer of Donegal Mutual and the Company from 2000 to 2005; Treasurer of Donegal Mutual and the Company from 1993 to 2000; Controller of Donegal Mutual and the Company from 1988 to 1995.
Jeffrey D. Miller	42	Senior Vice President and Chief Financial Officer of Donegal Mutual and the Company since 2005; Vice President and Controller of Donegal Mutual and the Company from 2000 to 2005; Controller of Donegal Mutual and the Company from 1995 to 2000.

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 42 of our Annual Report to Stockholders for the year ended December 31, 2006, which is included as Exhibit (13) to this Form 10-K Report. As of February 26, 2007, we had approximately 1,163 holders of record of our Class A common stock and 435 holders of record of our Class B common stock. We declared dividends of $0.30 per share on our Class A common stock and $0.26 per share on our Class B common stock in 2005 and $0.33 per share on our Class A common stock and $0.28 per share on our Class B common stock in 2006.

Between October 1, 2006 and December 31, 2006, we did not purchase any shares of our Class A common stock or Class B common stock. Between October 1, 2006 and December 31, 2006, Donegal Mutual purchased shares of our Class A common stock and Class B common stock as set forth in the following table.

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month #1	Class A – —	Class A – $—	Class A – —	
October 1-31, 2006	Class B – 112	Class B – $17.60	Class B – 112	(2)
Month #2	Class A – 3,333	Class A – $19.68	Class A – —	(1)
November 1-30, 2006	Class B – 10,937	Class B – $19.32	Class B – 817	(2)
Month #3	Class A – 75,000	Class A – $19.92	Class A – —	(1)
December 1-31, 2006	Class B – 2,466	Class B – $18.98	Class B – 1,300	(2)
Total	Class A – 78,333	Class A – $19.91	Class A – —	
	Class B – 13,515	Class B – $19.24	Class B – 2,229	

(1) Donegal Mutual purchased these shares in privately negotiated non-market transactions directly with its employees. These purchases were not pursuant to a publicly announced plan or program. Donegal Mutual has not limited the number of shares of Class A common stock or Class B common stock it may purchase from time to time in private market transactions directly with its employees.

(2) Donegal Mutual purchased these shares pursuant to its announcement on August 17, 2004 that it will, at its discretion, purchase shares of our Class A common stock and Class B common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. Such announcement did not stipulate a maximum number of shares that may be purchased.

Our performance graph is included on page 41 of our Annual Report to Stockholders for the year ended December 31, 2006, which is included as Exhibit (13) to this Form 10-K Report. Our performance graph is not deemed filed with the SEC and will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Exchange Act, except to the extent that we specifically incorporate it by reference.

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, 2006, 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 18 of our Annual Report to Stockholders for the year ended December 31, 2006, which is included as Exhibit (13) to this Form 10-K Report.

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

Our insurance subsidiaries 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, our insurance subsidiaries employ established policies and procedures to manage their exposure to changes in interest rates, fluctuations in the fair market value of our debt and equity securities and credit risk. Our insurance subsidiaries seek to mitigate these risks by various actions described below.

Interest Rate Risk

The exposure of our insurance subsidiaries to market risk for a change in interest rates is concentrated in their investment portfolios. Our insurance subsidiaries monitor this exposure through periodic reviews of asset and liability positions. Our insurance subsidiaries regularly monitor their estimates of cash flows and the impact of interest rate fluctuations relating to their investment portfolio. Generally, our insurance subsidiaries do not hedge their exposure to interest rate risk because they 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 held by our insurance subsidiaries are as follows:

(amounts in thousands)	As of December 31, 2006 Principal cash flows	Weighted-average interest rate
Fixed maturities and short-term investments:		
2007	$ 73,286	5.0%
2008	33,002	4.3
2009	40,752	4.4
20010	34,515	4.9
2011	17,367	4.8
Thereafter	338,014	4.6
Total	$ 536,936	
Market value	$ 541,578	
Debt:		
2033	$ 30,929	9.4%
Total	$ 30,929	
Fair Value	$ 30,929	

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

Equity Price Risk

The marketable equity securities portfolios of our insurance subsidiaries, which are carried on our consolidated balance sheets at estimated fair value, have exposure to price risk, which is the risk of potential loss in estimated fair value resulting from an adverse change in prices. The objective of our insurance subsidiaries is to earn competitive relative returns by investing in diverse portfolios of high-quality, liquid securities.

Credit Risk

The fixed-maturity securities portfolios of our insurance subsidiaries and, to a lesser extent, the short-term investments of our insurance subsidiaries are subject to credit risk. This risk is the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. Our insurance subsidiaries manage this risk by performing pre-investment underwriting analysis and through regular reviews by their investment staff. The amount of fixed maturity investments of our insurance subsidiaries is limited to a minimum and maximum percentage of their total unvested assets.

Our insurance subsidiaries provide property and casualty insurance coverages through a network of independent insurance agencies located throughout the operating areas of our insurance subsidiaries. The majority of this business is billed directly to the policyholder, although a portion of our commercial business is billed through the agents of our insurance subsidiaries, who extend credit to agents in the normal course of their business.

Our insurance subsidiaries place reinsurance with Donegal Mutual and with major unaffiliated authorized reinsurers. To the extent that a reinsurer may be unable to pay losses for which it is liable to our insurance subsidiaries under the terms of its reinsurance agreement with our insurance subsidiaries, our insurance subsidiaries remain liable for such losses.

Item 8. Financial Statements and Supplementary Data.

The response to this Item is incorporated by reference to pages 19 through 37 of our Annual Report to Stockholders for the year ended December 31, 2006, 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 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 and our disclosure controls and procedures are also effective to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

Pursuant to Section 404 of Sarbanes-Oxley, a report of management's assessment of the design and effectiveness of our internal controls is included as part of our Annual Report to Stockholders incorporated by reference in this Form 10-K Annual Report. KPMG LLP, an independent registered public accounting firm, audited the effectiveness of our internal control over financial reporting as of December 31, 2006 based on criteria establish by Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The report of KPMG dated March 13, 2007 is

included as part of our Annual Report to Stockholders incorporated by reference in this Form 10-K Annual Report.

Changes in Internal Control over Financial Reporting

We have not changed 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 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information.

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance of the Registrant.

The response to this Item with respect to our directors is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 19, 2007. The response to this Item with respect to our executive officers is incorporated by reference to Part I of this Form 10-K Report.

The full text of our Code of Ethics is incorporated by reference as noted with respect to Exhibit 14 to this Form 10-K Report.

Item 11. Executive Compensation.

The response to this Item is incorporated by reference to our proxy statement filed with the SEC relating to our annual meeting of stockholders to be held April 19, 2007. Neither the Report of our Compensation Committee nor the Report of our Audit Committee is deemed filed with the SEC or will be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent we specifically incorporate it 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 our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 19, 2007.

Item 13. Certain Relationships and Related Transactions and Director Independence.

The response to this Item is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 19, 2007.

Item 14. Principal Accountant Fees and Services.

The response to this Item is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 19, 2007.

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PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a) Financial statements, financial statement schedules and exhibits filed:

(a) Consolidated Financial Statements

	Page*
Reports of Independent Registered Public Accounting Firm	38, 40
Donegal Group Inc. and Subsidiaries:	
Consolidated Balance Sheets as of December 31, 2006 and 2005	19
Consolidated Statements of Income and Comprehensive Income for each of the years in the three-year period ended December 31, 2006, 2005 and 2004	20
Consolidated Statements of Stockholders' Equity for each of the years in the three-year period ended December 31, 2006, 2005 and 2004	21
Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2006, 2005 and 2004	22
Notes to Consolidated Financial Statements	23
Report and Consent of Independent Registered Public Accounting Firm	Exhibit 23

(b) Financial Statement Schedules

	Page
Donegal Group Inc. and Subsidiaries	
Schedule III – Supplementary Insurance Information	S-1

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 2006 Annual Report to Stockholders. The Consolidated Financial Statements and Notes to Consolidated Financial Statements, Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements, Management's Report on Internal Control over Financial Reporting and Report of Independent Registered

Public Accounting Firm on Internal Control Over Financial Reporting on pages 19 through 40 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.

(c) 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.	(t)
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. 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)

Exhibit No.	Description of Exhibits	Reference
(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)
Other Material Contracts		
(10)(N)	Amended and Restated Tax Sharing Agreement dated as of October 19, 2006 among Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company and Peninsula Indemnity Company.	(r)
(10)(O)	Amended and Restated Services Allocation Agreement dated July 20, 2006 among Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company, Le Mars Insurance Company, The Peninsula Insurance Company, Peninsula Indemnity Company and Donegal Mutual Insurance Company.	(b)
(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)	Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(k)
(10)(S)	Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(l)
(10)(T)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia.	(h)
(10)(U)	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)

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Exhibit No.	Description of Exhibits	Reference
(10)(V)	First Amendment and Waiver to the Amended and Restated Credit Agreement dated as of December 31, 1999.	(g)
(10)(W)	Amendment dated as of April 20, 2000 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(n)
(10)(X)	Lease Agreement dated as of September 1, 2000 between Donegal Mutual Insurance Company and Province Bank FSB.	(d)
(10)(Y)	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)(Z)	Plan of Conversion of Le Mars Mutual Insurance Company of Iowa adopted August 11, 2003	(p)
(10)(AA)	Stock Purchase Agreement dated as of October 28, 2003 between Donegal Group Inc. and Folksamerica Holding Company, Inc.	(o)
(10)(BB)	Credit Agreement dated as of November 25, 2003 between Donegal Group Inc. and Manufacturers and Traders Trust Company	(p)
(10)(CC)	First Amendment to Credit Agreement dated as of July 20, 2006 between Donegal Group Inc. and Manufacturers and Traders Trust Company	(b)
(10)(DD)	Amended and Restated Services Allocation Agreement dated October 19, 2006 among Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company, Peninsula Indemnity Company and Donegal Mutual Insurance Company	(s)
(13)	2006 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K Report).	Filed herewith

Exhibit No.	Description of Exhibits	Reference
(14)	Code of Ethics	(q)
(21)	Subsidiaries of Registrant.	Filed herewith
(23)	Report and Consent of Independent Registered Public Accounting Firm	Filed herewith
(31.1)	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer	Filed herewith
(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 Certificate of Chief Financial Officer	Filed herewith

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(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 Registration Statement No. 333-63102 declared effective February 8, 2002.

(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 like-described exhibits in Registrant's Form 8-K Report dated November 3, 2003.

(p) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 1, 2003.

(q) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Annual Report for the year ended December 31, 2003.

(r) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated October 23, 2006.

(s) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-Q Quarterly Report for the quarter ended September 30, 2006.

(t) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 22, 2006.

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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 13, 2007

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 13, 2007
/s/ Jeffrey D. Miller Jeffrey D. Miller	Senior Vice President and Chief Financial Officer (principal financial and accounting officer)	March 13, 2007
/s/ Robert S. Bolinger Robert S. Bolinger	Director	March 13, 2007
/s/ Patricia A. Gilmartin Patricia A. Gilmartin	Director	March 13, 2007

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Signature	Title	Date
/s/ Philip H. Glatfelter, II Philip H. Glatfelter, II	Director	March 13, 2007
/s/ John J. Lyons John J. Lyons	Director	March 13, 2007
Jon M. Mahan	Director	March , 2007
/s/ S. Trezevant Moore, Jr. S. Trezevant Moore, Jr.	Director	March 13, 2007
/s/ R. Richard Sherbahn R. Richard Sherbahn	Director	March 13, 2007
/s/ Richard D. Wampler, II Richard D. Wampler, II	Director	March 13, 2007

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

Years Ended December 31, 2006, 2005 and 2004

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, 2006						
Personal lines	$ 185,951	$ —	$ 112,924	$ 29,973	$ 30,822	$ 192,980
Commercial lines	115,527	—	55,497	18,622	19,149	114,427
Investments	—	21,320	—	—	—	—
	$ 301,478	$ 21,320	$ 168,421	$ 48,595	$ 49,971	$ 307,407
Year Ended December 31, 2005						
Personal lines	$ 181,787	—	$ 107,788	$ 29,156	$ 29,113	$ 184,828
Commercial lines	112,711	—	59,754	18,078	18,050	117,716
Investments	—	18,472	—	—	—	—
	$ 294,498	$ 18,472	$ 167,542	$ 47,234	$ 47,163	$ 302,544
Year Ended December 31, 2004						
Personal lines	$ 167,401	$ —	$ 104,664	$ 24,832	$ 26,790	$ 176,156
Commercial lines	98,438	—	59,477	14,602	15,754	107,126
Investments	—	15,907	—	—	—	—
	$ 265,839	$ 15,907	$ 164,141	$ 39,434	$ 42,544	$ 283,282

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
2006				
Personal lines	$ 15,190	$ 115,524	$ 120,898	$ —
Commercial lines	9,549	143,498	76,005	—
Investments	—	—	—	—
	$ 24,739	$ 259,022	$ 196,903	$ —
2005				
Personal lines	$ 13,922	$ 119,313	$ 110,689	$ —
Commercial lines	9,555	146,417	75,971	—
Investments	—	—	—	—
	$ 23,477	$ 265,730	$ 186,660	$ —

Selected Consolidated Financial Data

Year Ended December 31,	**2006**	2005*	2004*	2003*	2002*
Income Statement Data					
Premiums earned	$301,478,162	$294,498,023	$265,838,594	$196,792,696	$185,841,193
Investment income, net	21,320,081	18,471,963	15,906,728	13,315,936	14,581,252
Realized investment gains	1,829,539	1,802,809	1,466,220	1,368,031	144,190
Total revenues	329,967,034	319,847,194	287,788,638	214,992,328	203,803,561
Income before income taxes and extraordinary gain	56,622,263	52,345,495	37,054,251	25,436,375	16,494,584
Income taxes	16,407,541	15,395,998	10,885,652	7,142,399	4,491,862
Extraordinary gain	—	—	5,445,670	—	—
Net income	40,214,722	36,949,497	31,614,269	18,293,976	12,002,722
Basic earnings per common share	1.61	1.54	1.35	1.07	.74
Diluted earnings per common share	1.57	1.49	1.31	1.04	.74
Cash dividends per share of Class A common stock	.33	.30	.27	.24	.23
Cash dividends per share of Class B common stock	.28	.26	.24	.22	.20
Balance Sheet Data at Year End					
Total investments	$591,337,674	$547,746,114	$499,069,332	$421,276,467	$332,299,094
Total assets	831,697,811	781,421,588	735,415,401	602,036,042	501,218,164
Debt obligations	30,929,000	30,929,000	30,929,000	25,774,000	19,800,000
Stockholders’ equity	320,802,262	277,896,186	242,704,314	208,649,232	133,182,850
Book value per share	12.70	11.30	10.15	9.17	8.17

* Per share information has been restated to reflect a 4-for-3 stock split effected in the form of a 33 1/3% stock dividend on April 26, 2006.

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Management's Discussion and Analysis of Results of Operations and Financial Condition

General

We were organized as an insurance holding company by Donegal Mutual Insurance Company ("Donegal Mutual") on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Le Mars Insurance Company ("Le Mars") and the Peninsula Insurance Group ("Peninsula"), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in the Mid-Atlantic, Midwest and Southern states. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies. We acquired Le Mars and Peninsula on January 1, 2004, and their results of operations have been included in our consolidated results of operations from that date. We also own 48.2% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a thrift holding company. Donegal Mutual owns the remaining 51.8% of the outstanding stock of DFSC.

At December 31, 2006, Donegal Mutual held approximately 41% of our outstanding Class A common stock and approximately 69% of our outstanding Class B common stock. The operations of our insurance subsidiaries are interrelated with the operations of Donegal Mutual and, while maintaining the separate corporate existence of each company, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

On April 6, 2006, our board of directors approved a four-for-three stock split of our Class A common stock and our Class B common stock effected in the form of a 33 1/3% stock dividend to stockholders of record at the close of business on April 17, 2006 and paid on April 26, 2006. The capital stock accounts, all share amounts and earnings per share amounts for 2005 and prior years have been restated to reflect this stock split.

On February 17, 2005, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33 1/3 % stock dividend with a record date of March 1, 2005 and a distribution date of March 28, 2005.

On September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, "Shelby"), part of Vesta Insurance Group, Inc. The agreement granted those members the right, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby's personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby's plans of withdrawal from those three states. As part of the agreement, those members paid specified amounts to Shelby based on the direct premiums written by those members on the renewal and replacement policies they issued. Net premiums written related to this agreement amounted to $4.8 million in 2006 and $0 in 2005.

Pooling Agreement and Other Transactions with Affiliates

In the mid-1980s, Donegal Mutual, like a number of other mutual property and casualty insurance companies, recognized the need to develop additional sources of capital and surplus to remain competitive, have the capacity to expand its business and assure its long-term viability. Donegal Mutual, again like a number of other mutual property and casualty insurance companies, determined to implement a downstream holding company structure as a strategic response. Thus, in 1986, Donegal Mutual formed us as a downstream holding company, then wholly owned by Donegal Mutual, and caused us to form Atlantic States as our wholly owned subsidiary. As part of the implementation of this strategy, Donegal Mutual and Atlantic States entered into a pooling agreement in 1986, whereby each company contributed all of its direct written business to the pool and the pool then allocated a portion of the pooled business to Donegal Mutual and Atlantic States. The consideration to Donegal Mutual for entering into the pooling agreement was its ownership of our capital stock and the expectation that Donegal Mutual's surplus would increase over time as the value of its ownership interest in us increased.

Since 1986, we have completed three public offerings. A major purpose of those offerings was to provide capital for Atlantic States and our other insurance subsidiaries and to fund acquisitions. As the capital of Atlantic States increased, its underwriting capacity increased proportionately. Thus, as originally planned in the mid-1980s, Atlantic States has had access to the capital necessary to support the growth of its direct business and increases in the amount and percentage of business it assumes from the underwriting pool with Donegal Mutual. As a result, the participation of Atlantic States in the underwriting pool has increased over the years from its initial 35% participation in 1986 to its current 70% participation, and the size of the pool has increased substantially. We do not anticipate any changes in the pooling agreement with Donegal Mutual, including any change in Atlantic States' pool participation level, in the foreseeable future.

The risk profiles of the business written by Atlantic States and Donegal Mutual historically have been, and continue to be, substantially similar. The products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries are determined and administered by the same management and underwriting personnel. In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products offered by our insurance subsidiaries and Donegal Mutual are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the pool and each company shares the results according to its participation level, Atlantic States realizes 70% of the underwriting profitability of the pool (because of its 70% participation in the pool), while Donegal Mutual realizes 30% of the underwriting profitability of the pool (because of Donegal Mutual's 30% participation in the pool).

Pooled business represents the predominant percentage of the net underwriting activity of both Donegal Mutual and Atlantic States.
See Note 3 – Transactions with Affiliates for more information regarding the pooling agreement.

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

- catastrophe reinsurance agreements with Atlantic States, Le Mars and Southern,
- an excess of loss reinsurance agreement with Southern,
- a quota-share reinsurance agreement with Peninsula (effective August 1, 2005) and
- a quota-share reinsurance agreement with Southern (effective October 1, 2005)

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

The quota-share reinsurance agreement with Peninsula is intended to transfer to Donegal Mutual 100% of the premiums and losses related to the Pennsylvania workers' compensation product line of Peninsula Indemnity Company, which provides the availability of an additional workers' compensation tier to Donegal Mutual's commercial accounts in Pennsylvania.

The quota-share reinsurance agreement with Southern is intended to transfer to Southern 100% of the premiums and losses related to certain personal lines products offered in Virginia by Donegal Mutual through the use of its automated policy quoting and issuance system.

Until December 31, 2006, Donegal Mutual had an agreement in place with Southern to reallocate the loss results of workers' compensation business written by Southern as part of commercial accounts primarily written by Donegal Mutual or Atlantic States. This agreement provided for the workers' compensation loss ratio of Southern to be no worse than the average workers' compensation loss ratio for Atlantic States, Southern and Donegal Mutual combined.

Donegal Mutual also has 100% retrocessional agreements with Southern and Le Mars. The retrocessional agreements are intended to ensure that Southern and Le Mars receive the same A.M. Best rating, currently A (Excellent), as Donegal Mutual. The retrocessional agreements do not otherwise provide for pooling or reinsurance with or by Donegal Mutual and do not transfer insurance risk.

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

All agreements and all changes to existing agreements between our insurance subsidiaries and Donegal Mutual are subject to approval by a coordinating committee that is comprised of two of our board members who do not serve on Donegal Mutual's board and two board members of Donegal Mutual 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 Donegal Mutual's members on the coordinating committee must conclude that the agreement or change is fair to Donegal Mutual and its policyholders.

There were no significant changes to the pooling agreement or other reinsurance agreements between our insurance subsidiaries and Donegal Mutual during 2006 and 2005, except as noted above.

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.

Our insurance subsidiaries 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 the reserves of our insurance subsidiaries for property and casualty insurance unpaid losses and loss expenses, valuation of investments and our insurance subsidiaries' policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the estimates provided. The methods for making these estimates are regularly reviewed, and any adjustment considered necessary is reflected in our current results of operations.

Liability for Losses and Loss Expenses

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

Our insurance subsidiaries maintain liabilities for the 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. Our insurance subsidiaries 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. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends, and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries' liabilities for losses are not discounted.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions as to our insurance subsidiaries' internal operations. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions, stability

in economic conditions and the rate of loss cost inflation. For example, our insurance subsidiaries have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectibility of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at December 31, 2006. For every 1% change in our insurance subsidiaries' estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately $1.6 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that our insurance subsidiaries' ultimate liability will not exceed our insurance subsidiaries' loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities cannot be predicted, since the historical conditions and events that serve as a basis for our insurance subsidiaries' estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods their estimates have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimate of the liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. Our insurance subsidiaries recognized a decrease in the liability for losses and loss expenses of prior years of $13.6 million, $9.4 million and $7.2 million in 2006, 2005 and 2004, respectively. Generally, our insurance subsidiaries experienced improving loss development trends during these years, which were reflected in favorable settlements of open claims. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management during these years, even though they reflected changes in their reserve estimates in these years. No significant offsetting changes in estimates increased or decreased our insurance subsidiaries' loss and loss expense reserves in these years. The 2006 development was primarily recognized in the workers' compensation, private passenger automobile liability and commercial multi-peril lines of business and was consistently favorable for settlements of claims occurring in each of the previous five accident years. The majority of the 2006 development was related to decreases in the liability for losses and loss expenses of prior years for Atlantic States.

Excluding the impact of isolated catastrophic weather events, our insurance subsidiaries have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most of their lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic conditions extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims. Further adjustments to our insurance subsidiaries' estimates could be required in the future. However, on the basis of our insurance subsidiaries' internal procedures, which analyze, among other things, their prior assumptions, their 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 our insurance subsidiaries have made adequate provision for their liability for losses and loss expenses.

Because of Atlantic States' participation in the underwriting pool with Donegal Mutual, Atlantic States is exposed to adverse loss development on the business of Donegal Mutual that is included in the pool. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and Donegal Mutual and Atlantic States would proportionately share any adverse risk development of the pooled business. The business in the underwriting pool is homogenous (i.e., Atlantic States has a 70% share of the entire pool and Donegal Mutual has a 30% share of the entire pool). Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for each company than they would experience individually and to spread the risk of loss among each company.

Our insurance subsidiaries' liability for losses and loss expenses by major line of business as of December 31, 2006 consisted of the following:

(in thousands)	2006	2005
Commercial lines:		
Automobile	$ 23,406	$ 23,532
Workers' compensation	39,563	40,962
Commercial multi-peril	25,994	29,448
Other	2,633	3,088
Total commercial lines	91,596	97,030
Personal lines:		
Automobile	59,657	63,254
Homeowners	10,360	10,900
Other	1,699	1,825
Total personal lines	71,716	75,979
Total commercial and personal lines	163,312	173,009
Plus reinsurance recoverable	95,710	92,721
Total liability for losses and loss expenses	$259,022	$265,730

We have evaluated the effect on our insurance subsidiaries' loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables considered in establishing loss and loss expense reserves. The range of reasonably likely changes was established based on a review of changes in accident year development by line of business and applied to our insurance subsidiaries' loss reserves as a whole. The selected range does not necessarily indicate what could be the potential best or worst case or likely scenario. The following table sets forth the effect on our insurance subsidiaries' loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables considered in establishing loss and loss expense reserves:

Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2006	Percentage Change in Equity as of December 31, 2006(1)	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2005	Percentage Change in Equity as of December 31, 2005(1)
	(dollars in thousands)			
-10.0%	$ 146,981	3.3%	$ 155,708	4.0%
-7.5	151,064	2.5	160,033	3.0
-5.0	155,146	1.7	164,359	2.0
-2.5	159,229	0.8	168,684	1.0
Base	163,312	—	173,009	—
2.5	167,395	-0.8	177,334	-1.0
5.0	171,478	-1.7	181,659	-2.0
7.5	175,560	-2.5	185,985	-3.0
10.0	179,643	-3.3	190,310	-4.0

(1) Net of income tax effect.

Our insurance subsidiaries' reserve for unpaid losses and loss expenses is based on current trends in loss and loss expense development and reflects their best estimate for future amounts needed to pay losses and loss expenses with respect to incurred events currently known to them plus incurred but not reported ("IBNR") claims. Reserve estimates are based on management's assessment of known facts and circumstances, review of historical loss settlement patterns, estimates of trends in claims severity, frequency, legal and regulatory changes and other assumptions. Actuarial loss reserving techniques and assumptions, which rely on historical information as adjusted to reflect current conditions, have been consistently applied, including consideration of recent case reserve activity. For the year ended December 31, 2006, our insurance subsidiaries used the most-likely number as determined by our actuaries. Based upon information provided by our actuaries during the development of our insurance subsidiaries' net reserves for losses and loss expenses for the year ended December 31, 2006, we developed a range from a low of $153.8 million to a high of $173.4 million and with a most-likely number of $163.3 million. The range of estimates for commercial lines in 2006 was $86.3 million to $97.2 million (we selected the actuaries' most-likely number of $91.6 million) and for personal lines in 2006 was $67.5 million to $76.1 million (we selected the actuaries' most-likely number of $71.7 million). Based upon information provided by our actuaries during the development of our insurance subsidiaries' net reserves for losses and loss expenses for the year ended December 31, 2005, we developed a range from a low of $156.8 million to a high of $189.2 million and with a most-likely number of $173.0 million. The range of estimates for commercial lines in 2005 was $87.9 million to $106.1 million (we selected the actuaries' most-likely number of $97.0 million) and for personal lines in 2005 was $68.9 million to $83.1 million (we selected the actuaries' most-likely number of $76.0 million).

Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite. For personal lines products, our insurance subsidiaries insure standard and preferred risks in private passenger automobile and homeowners lines. For commercial lines products, the commercial risks that our insurance subsidiaries primarily insure are mercantile risks, business offices, wholesalers, service providers, contractors and artisan risks, limiting industrial and manufacturing exposures. Our insurance subsidiaries have limited exposure to asbestos and other environmental liabilities. Our insurance subsidiaries write no medical malpractice or professional liability risks. Through the consistent application of this disciplined underwriting philosophy, our insurance subsidiaries have avoided many of the "long-tail" issues faced by other insurance companies. We consider workers' compensation to be a "long-tail" line of business, in that workers' compensation claims tend to be settled over a longer timeframe than those in our insurance subsidiaries' other lines of business. The following table presents 2006 and 2005 claim count and payment amount information for workers' compensation. Workers' compensation losses primarily consist of indemnity and medical costs for injured workers. Substantially all of the claims are relatively small individual claims of a similar type.

	For the Year Ended December 31,	
	2006	2005
	(dollars in thousands)	
Number of claims pending, beginning of period	1,724	1,676
Number of claims reported	3,931	3,865
Number of claims settled or dismissed	4,312	3,817
Number of claims pending, end of period	1,343	1,724
Losses paid	$15,700	$15,297
Loss expenses paid	2,936	3,203

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 and the occurrence of industry, company and geographic events that have negatively impacted the value of a security or rating agency downgrades. When determining possible impairment of our debt securities, we consider unrealized losses that are due to the impact of higher market interest rates to be temporary in nature because we have the ability and intent to hold our debt securities to recovery.

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

During 2005, we sold bonds that had been classified as held to maturity due to significant deterioration in the issuer's creditworthiness. These bonds had an amortized cost of $1.0 million, and the sale resulted in a realized loss of $144,047. There were no other sales or transfers from the held to maturity portfolio in 2006, 2005 or 2004.

Policy Acquisition Costs

Our insurance subsidiaries’ 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.

Management Evaluation of Operating Results

We believe that principal factors in our earnings growth in the past several years have been the favorable market conditions in the areas in which our insurance subsidiaries operate, their overall premium growth, earnings from acquisitions and our insurance subsidiaries' disciplined underwriting practices.

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 and other factors. The level of surplus in the industry varies with returns on capital and regulatory barriers to the withdrawal of surplus. Increases in surplus have generally been accompanied by increased price competition among property and casualty insurers. If our insurance subsidiaries were to find it necessary to reduce premiums or limit premium increases due to competitive pressures on pricing, our insurance subsidiaries could experience a reduction in profit margins and revenues, an increase in ratios of losses and expenses to premiums and, therefore, lower profitability. The cyclicality of the insurance market and its potential impact on our results is difficult to predict with any significant reliability.

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

	Year Ended December 31,		
(in thousands)	2006	2005	2004
Net premiums written:			
Personal lines:			
Automobile	$126,211	$122,059	$118,734
Homeowners	56,005	52,149	47,540
Other	10,764	10,620	9,882
Total personal lines	192,980	184,828	176,156
Commercial lines:			
Automobile	33,387	34,641	32,679
Workers' compensation	32,845	33,154	29,228
Commercial multi-peril	44,750	46,406	42,253
Other	3,445	3,515	2,966
Total commercial lines	114,427	117,716	107,126
Total net premiums written	$307,407	$302,544	$283,282

	Year Ended December 31,		
(in thousands)	2006	2005	2004
Components of GAAP combined ratio:			
Loss ratio	55.8%	56.9%	61.7%
Expense ratio	32.7	32.1	30.9
Dividend ratio	0.5	0.5	0.5
GAAP combined ratio	89.0%	89.5%	93.1%
Revenues:			
Premiums earned:			
Personal lines	$185,951	$181,787	$169,322
Commercial lines	115,527	112,711	99,657
Total SAP premiums earned	301,478	294,498	268,979
GAAP adjustments	—	—	(3,140)
Total GAAP premiums earned	301,478	294,498	265,839
Net investment income	21,320	18,472	15,907
Realized investment gains	1,830	1,803	1,466
Other	5,339	5,074	4,577
Total revenues	$329,967	$319,847	$287,789
Components of net income:			
Underwriting income:			
Personal lines	$ 9,288	$ 14,232	$ 10,100
Commercial lines	22,495	13,941	6,209
SAP underwriting income	31,783	28,173	16,309
GAAP adjustments	1,270	2,765	2,109
GAAP underwriting income	33,053	30,938	18,418
Net investment income	21,320	18,472	15,907
Realized investment gains	1,830	1,803	1,466
Other	419	1,132	1,263
Income before income tax expense and extraordinary item	56,622	52,345	37,054
Income tax expense	(16,407)	(15,396)	(10,886)
Income before extraordinary item	40,215	36,949	26,168
Extraordinary gain	—	—	5,446
Net income	$ 40,215	$ 36,949	$ 31,614

Results of Operations
Years Ended December 31, 2006 and 2005

Net Premiums Written

Our insurance subsidiaries' 2006 net premiums written increased by 1.6% to $307.4 million, compared to $302.5 million for 2005. Commercial lines net premiums written decreased $3.3 million, or 2.8%, for 2006 compared to 2005. Personal lines net premiums written increased $8.2 million, or 4.4%, for 2006 compared to 2005. Our insurance subsidiaries have benefited in 2006 from the addition of the personal lines new business related to increased agent utilization of our WritePro automated underwriting system and the Shelby acquisition rights agreement. Net premiums written related to the acquisition rights agreement amounted to $4.8 million during 2006.

Net Premiums Earned

Our insurance subsidiaries' net premiums earned increased to $301.5 million for 2006, an increase of $7.0 million, or 2.4%, over 2005. Our insurance subsidiaries' net earned premiums during 2006 have grown due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of the policies issued by our insurance subsidiaries, 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 2006, our net investment income increased 15.1% to $21.3 million, compared to $18.5 million for 2005. An increase in our average invested assets from $523.4 million in 2005 to $569.5 million in 2006 primarily accounted for the increase in investment income in 2006 compared to 2005. Our annualized average return increased to 3.7% compared to 3.5% in 2005. The increase in our annualized average return reflects a shift from short-term investments to higher-yielding fixed maturities in our investment portfolio as well as higher short-term interest rates during 2006 compared to 2005. These increases were offset in part by decreases in our annualized average rate of return on our increased holdings of tax-exempt fixed maturities in our investment portfolio during 2006 compared to 2005. The increased holdings of tax-exempt fixed maturities in 2006 resulted from a shift from taxable to tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

Installment Payment Fees

Our insurance subsidiaries' installment fees increased primarily as a result of increases in fee rates and policy counts during 2006.

Net Realized Investment Gains/Losses

Our net realized investment gains in 2006 and 2005 were $1.8 million. Our net realized investment gains in 2006 were net of impairment charges of $47,538, compared to impairment charges of $409,432 recognized in 2005. Our impairment charges for both years were the result of declines in the market value of equity securities 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 insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in 2006 was 55.8%, compared to 56.9% in 2005. Our insurance subsidiaries' commercial lines loss ratio decreased to 48.0% in 2006, compared to 53.0% in 2005. This decrease primarily resulted from the workers' compensation loss ratio decreasing to 53.4% in 2006, compared to 68.0% in 2005. The personal lines loss ratio increased slightly from 59.3% in 2005 to 60.7% in 2006, primarily as a result of an increase in the personal automobile loss ratio to 64.2% in 2006, compared to 62.4% in 2005, and an increase in the homeowners loss ratio to 57.4% in 2006, compared to 54.9% in 2005, as a result of an increase in weather-related claims. Our insurance subsidiaries' 2006 loss ratios reflect the benefits of decreased claim frequency and favorable prior accident year loss development of $13.6 million in 2006, compared to favorable prior accident year loss development of $9.4 million in 2005. Favorable prior accident year loss development in both years was largely due to favorable settlements of open claims.

Underwriting Expenses

Our insurance subsidiaries' expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, was 32.7% in 2006, compared to 32.1% in 2005. The expense ratio in 2005 benefited from a reduction in estimated guaranty fund assessments.

Combined Ratio

Our insurance subsidiaries' combined ratio was 89.0% and 89.5% in 2006 and 2005, 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.

Interest Expense

Our interest expense in 2006 was $2.8 million, compared to $2.3 million in 2005, reflecting increases in the average interest rates on our subordinated debentures compared to 2005.

Income Taxes

Our income tax expense was $16.4 million in 2006, compared to $15.4 million in 2005, representing an effective tax rate of 29.0% compared to 29.4% in 2005. The change in effective tax rates is primarily due to tax-exempt interest income representing a larger proportion of income before income tax expense in 2006 compared to 2005, as we benefited from a 17.3% increase in tax-exempt interest income in 2006 compared to 2005.

Net Income and Earnings Per Share

Our net income in 2006 was $40.2 million, an increase of 8.9% over the $36.9 million reported in 2005. Our diluted earnings per share were $1.57 in 2006, compared to $1.49 in 2005. Our fully diluted shares outstanding for 2006 increased to 25.6 million, compared to 24.8 million for 2005.

Book Value Per Share and Return on Equity

Our stockholders' equity increased by $42.9 million in 2006, primarily as a result of favorable operating results. Book value per share increased by 12.4% to $12.70 at December 31, 2006, compared to $11.30 a year earlier. Our return on average equity was 13.4% in 2006, compared to 14.2% in 2005.

Results of Operations
Years Ended December 31, 2005 and 2004

Net Premiums Written

Our insurance subsidiaries' 2005 net premiums written increased by 6.8% to $302.5 million, compared to $283.3 million for 2004. Commercial lines net premiums written increased $10.6 million, or 9.9%, for 2005 compared to 2004. Personal lines net premiums written increased $8.7 million, or 4.9%, for 2005 compared to 2004. Our insurance subsidiaries have benefited during these periods from premium increases that resulted from pricing actions approved by regulators. These increases related primarily to private passenger automobile, commercial multi-peril, workers' compensation and homeowners lines of business realized in most of the states in which our insurance subsidiaries operate. In addition to acquisition growth and pricing increases, our insurance subsidiaries have also benefited from organic growth in most of the states in which they operate.

Net Premiums Earned

Our insurance subsidiaries' net premiums earned increased to $294.5 million for 2005, an increase of $28.7 million, or 10.8%, over 2004. Our insurance subsidiaries' net earned premiums during 2005 have grown due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of the policies issued by our insurance subsidiaries, 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 2005, our net investment income increased 16.4% to $18.5 million, compared to $15.9 million for 2004. An increase in our average invested assets from $460.2 million in 2004 to $523.4 million in 2005 primarily accounted for the increase in investment income in 2005 compared to 2004. Our annualized average return was 3.5% during both years. Although we realized increases in our annualized average return as a result of a shift from short-term investments to higher yielding fixed maturities in our investment portfolio as well as higher short-term interest rates during 2005 compared to 2004, these increases were offset by decreases in our annualized average return on increased holdings of tax-exempt fixed maturities in our investment portfolio during 2005. The increased holdings of tax-exempt fixed maturities in 2005 resulted from a shift from taxable to tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

Installment Payment Fees

Our insurance subsidiaries' installment fees increased primarily as a result of increases in fee rates and policy counts during 2005.

Net Realized Investment Gains/Losses

Our net realized investment gains in 2005 were $1.8 million, compared to $1.5 million in 2004. Our net realized investment gains in 2005 were net of impairment charges of $409,432, compared to impairment charges of $6,650 recognized in 2004. Our impairment charges for both years were the result of declines in the market value of equity securities 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 insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in 2005 was 56.9%, compared to 61.7% in 2004. Our insurance subsidiaries' commercial lines loss ratio decreased to 53.0% in 2005, compared to 60.4% in 2004. This decrease primarily resulted from the workers' compensation loss ratio decreasing to 68.0% in 2005, compared to 87.2% in 2004. The personal lines loss ratio improved from 62.5% in 2004 to 59.3% in 2005, primarily as a result of improvement in the personal automobile loss ratio to 62.4% in 2005, compared to 65.5% in 2004, and improvement in the homeowners loss ratio to 54.9% in 2005, compared to 56.4% in 2004. Improvements in our insurance subsidiaries' 2005 loss ratios reflect the benefits of premium pricing increases, decreased claim frequency and favorable prior accident year loss development of $9.4 million in 2005, compared to favorable prior accident year loss development of $7.2 million in 2004. Favorable prior accident year loss development in both years was largely due to favorable settlements of open claims. The 2004 workers' compensation loss ratio was adversely impacted by reserve strengthening based upon past development trends in this line of business.

Underwriting Expenses

Our insurance subsidiaries' expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, in 2005 was 32.1%, compared to 30.9% in 2004. Improvements from expense control efforts and reduced guaranty fund assessments were offset by higher underwriting-based incentive costs incurred in 2005 compared to 2004.

Combined Ratio

Our insurance subsidiaries' combined ratio was 89.5% and 93.1% in 2005 and 2004, 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.

Interest Expense

Our interest expense in 2005 was $2.3 million, compared to $1.6 million in 2004, reflecting increases in the average interest rates on our subordinated debentures compared to 2004.

Income Taxes

Our income tax expense was $15.4 million in 2005, compared to $10.9 million in 2004, representing effective tax rates of 29.4% in both years. The effective tax rate remained constant in both years primarily due to tax-exempt interest income representing a smaller proportion of income before income tax expense in 2005 compared to 2004, notwithstanding a 45.5% increase in tax-exempt interest income in 2005 compared to 2004.

Net Income and Earnings Per Share

Our net income in 2005 was $36.9 million, an increase of 16.8% over the $31.6 million reported in 2004. Our diluted earnings per share were $1.49 in 2005, compared to $1.31 in 2004. Our net income for 2004 included an extraordinary gain of $5.4 million, or $.23 per share on a diluted basis, related to an acquisition. Our fully diluted shares outstanding for 2005 increased to 24.8 million, compared to 24.3 million for 2004.

Book Value Per Share and Return on Equity

Our stockholders' equity increased by $35.2 million in 2005, primarily as a result of favorable operating results. Book value per share increased by 11.4% to $11.30 at December 31, 2005, compared to $10.15 a year earlier. Our return on average equity was 14.2% in 2005, compared to 14.0% in 2004.

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 have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement with Donegal Mutual historically has been cash flow positive because of the historical profitability of the underwriting pool. The pool is settled monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. Our insurance subsidiaries have not experienced any unusual variations in the timing of claim payments associated with their loss reserves. 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. Our fixed-maturity investment portfolio is structured following a "laddering" approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations and the obligations of our insurance subsidiaries should an unexpected variation occur in the future. Net cash flows provided by operating activities in 2006, 2005 and 2004, were $33.8 million, $48.9 million and $34.0 million, respectively.

On May 24, 2004, we received $5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 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, 2006, the interest rate on the debentures was 9.22%.

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. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2006, we have the ability to borrow $35.0 million at interest rates equal to M&T'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 credit agreement requires our compliance with certain covenants, which include minimum levels of net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. During the years ended December 31, 2006 and 2005, no borrowings were outstanding, and we complied with all requirements of the credit agreement.

The following table shows expected payments for our significant contractual obligations as of December 31, 2006.

(in thousands)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Net liability for unpaid losses and loss expenses	$163,312	$70,150	$75,323	$8,532	$ 9,307
Subordinated debentures	30,929	—	—	—	30,929
Total contractual obligations	$194,241	$70,150	$75,323	$8,532	$40,236

The timing of the amounts for the net liability for unpaid losses and loss expenses of our insurance subsidiaries is estimated based on historical experience and expectations of future payment patterns. The liability has been shown net of reinsurance recoverable on unpaid losses and loss expenses to reflect expected future cash flows related to such liability. Assumed amounts from the underwriting pool with Donegal Mutual represent a substantial portion of our insurance subsidiaries' gross liability for unpaid losses and loss expenses, and ceded amounts to the underwriting pool represent a substantial portion of our insurance subsidiaries' reinsurance recoverable on unpaid losses and loss expenses. Future cash settlement of Atlantic States' assumed liability from the pool will be included in monthly settlements of pooled activity, wherein amounts ceded to and assumed from the pool are netted. Although Donegal Mutual and Atlantic States do not anticipate any changes in the pool participation levels in the foreseeable future, any such change would be prospective in nature and therefore would not impact the timing of expected payments for Atlantic States' proportionate liability for pooled losses occurring in periods prior to the effective date of such change.

Dividends declared to stockholders totaled $8.4 million, $7.0 million and $6.2 million in 2006, 2005 and 2004, 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. Our insurance subsidiaries 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. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2006, our insurance subsidiaries' capital were each substantially above the RBC requirements. In 2007, amounts available for distribution as dividends to us without prior approval of their domiciliary insurance regulatory authorities are $26.7 million from Atlantic States, $2.5 million from Le Mars, $3.3 million from Peninsula and $5.9 million from Southern.

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 $12.9 million in cash, including payment of $4.4 million to Donegal Mutual for a surplus note that Donegal Mutual had purchased from Le Mars and accrued interest thereon.

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 multi-peril.

As of January 1, 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 $23.5 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 multi-peril, workers' compensation and commercial automobile coverages. Peninsula's principal operating area includes Maryland, Delaware and Virginia.

Investments

At December 31, 2006 and 2005, our investment portfolio of investment-grade bonds, common stock, preferred stock, short-term investments and cash totaled $591.9 million and $551.6 million, respectively, representing 71.2% and 70.6%, respectively, of our total assets.

At December 31, 2006 and 2005, the carrying value of our fixed maturity investments represented 84.7% and 86.8% 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, 2006 and 2005. As we invested excess cash from operations and proceeds from maturities of fixed-maturity investments during 2006, we increased our holdings of tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

At December 31, 2006, the net unrealized gain on available-for-sale fixed maturities, net of deferred taxes, amounted to $802,404, compared to $0 at December 31, 2005.

At December 31, 2006, the net unrealized gain on our equity securities, net of deferred taxes, amounted to $4.6 million, compared to $2.5 million at December 31, 2005.

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 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, 2006 are as follows:

(in thousands)	Principal Cash Flows	Weighted-Average Interest Rate
Fixed maturities and short-term bonds:		
2007	$ 73,286	5.01%
2008	33,002	4.33
2009	40,752	4.39
2010	34,515	4.85
2011	17,367	4.79
Thereafter	338,014	4.63
Total	$536,936	
Market value	$541,578	
Debt:		
Thereafter	$ 30,929	9.35%
Total	$ 30,929	
Fair value	$ 30,929	

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

Equity Price Risk

Our portfolio of equity securities, which is carried on our 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, short-term investments is 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 an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the amount that any one security can constitute of our total investment portfolio.

Our insurance subsidiaries provide property and liability insurance coverages through independent insurance agencies located throughout their operating area. The majority of this business is billed directly to the insured, although a portion of our insurance subsidiaries' commercial business is billed through their agents to whom they extend credit in the normal course of business.

Because the pooling agreement does not relieve Atlantic States of primary liability as the originating insurer, Atlantic States is subject to a concentration of credit risk arising from business ceded to Donegal Mutual. Our insurance subsidiaries maintain reinsurance agreements in place with Donegal Mutual 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, our insurance subsidiaries attempt, in establishing rates, to anticipate the potential impact of inflation.

Impact of New Accounting Standards

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes." FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the impact of adopting FIN No. 48 to have a significant effect on our results of operation, financial condition or liquidity.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108 to address diversity in practice in quantifying financial statement misstatements. SAB No. 108 requires that registrants quantify the impact on the current year's financial statements of correcting all misstatements, including the carryover and reversing effects of prior years' misstatements, as well as the effects of errors arising in the current year. SAB No. 108 is effective as of the first fiscal year ending after November 15, 2006, allowing a one-time transitional cumulative effect adjustment to retained earnings as of January 1, 2006, for errors that were not previously deemed material, but are material under the guidance of SAB No. 108. We do not expect the provisions of SAB No. 108 to have a significant effect on our results of operations, financial condition or liquidity.

Donegal Group Inc.

Consolidated Balance Sheets

December 31,	2006	2005
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value $168,423,464 and $178,601,127)	$169,178,137	$180,182,305
Available for sale, at fair value (amortized cost $330,435,311 and $295,097,229)	331,669,778	295,097,235
Equity securities, available for sale, at fair value (cost $33,505,531 and $28,993,361)	40,541,826	33,371,360
Investments in affiliates	8,463,059	8,441,546
Short-term investments, at cost, which approximates fair value	41,484,874	30,653,668
Total investments	591,337,674	547,746,114
Cash	531,756	3,811,011
Accrued investment income	5,769,087	5,521,335
Premiums receivable	49,948,454	47,124,106
Reinsurance receivable	97,677,015	94,137,096
Deferred policy acquisition costs	24,738,929	23,476,593
Deferred tax asset, net	9,085,688	11,532,834
Prepaid reinsurance premiums	44,376,953	40,063,138
Property and equipment, net	5,146,305	5,234,423
Accounts receivable – securities	262,992	411,149
Federal income taxes recoverable	998,785	901,341
Other	1,824,173	1,462,448
Total assets	$831,697,811	$781,421,588
Liabilities and Stockholders' Equity		
Liabilities		
Losses and loss expenses	$259,022,459	$265,729,527
Unearned premiums	196,902,972	186,660,050
Accrued expenses	12,754,012	12,706,485
Reinsurance balances payable	2,034,972	1,814,292
Cash dividends declared to stockholders	2,442,958	1,781,393
Subordinated debentures	30,929,000	30,929,000
Accounts payable – securities	3,392,329	896,893
Due to affiliate	1,567,091	728,486
Drafts payable	381,744	703,912
Other	1,468,012	1,575,364
Total liabilities	510,895,549	503,525,402
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 19,834,248 and 19,156,169 shares and outstanding 19,689,318 and 19,011,268 shares	198,342	191,562*
Class B common stock, $.01 par value, authorized 10,000,000 shares, issued 5,649,240 and outstanding 5,576,775 shares	56,492	56,492*
Additional paid-in capital	152,391,301	141,932,954
Accumulated other comprehensive income	5,061,174	2,532,073
Retained earnings	163,986,701	134,074,853*
Treasury stock, at cost	(891,748)	(891,748)
Total stockholders' equity	320,802,262	277,896,186
Total liabilities and stockholders' equity	$831,697,811	$781,421,588

* All 2005 capital accounts and share information have been restated for a 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Income and Comprehensive Income

Year Ended December 31,	2006	2005	2004
Statements of Income			
Revenues			
Net premiums earned (includes affiliated reinsurance of $106,708,994, $104,228,169 and $100,773,324 – see footnote 3)	$301,478,162	$294,498,023	$265,838,594
Investment income, net of investment expenses	21,320,081	18,471,963	15,906,728
Installment payment fees	4,357,374	4,123,856	3,686,790
Lease income	981,878	950,543	890,306
Net realized investment gains	1,829,539	1,802,809	1,466,220
Total revenues	329,967,034	319,847,194	287,788,638
Expenses			
Net losses and loss expenses (includes affiliated reinsurance of $62,753,111, $60,284,232 and $55,109,122 – see footnote 3)	168,421,425	167,541,897	164,141,368
Amortization of deferred policy acquisition costs	48,595,000	47,234,000	39,434,000
Other underwriting expenses	49,970,717	47,163,396	42,544,166
Policy dividends	1,438,494	1,620,606	1,300,893
Interest	2,801,553	2,266,346	1,613,511
Other	2,117,582	1,675,454	1,700,449
Total expenses	273,344,771	267,501,699	250,734,387
Income before income tax expense and extraordinary item	56,622,263	52,345,495	37,054,251
Income tax expense	16,407,541	15,395,998	10,885,652
Income before extraordinary item	40,214,722	36,949,497	26,168,599
Extraordinary gain – unallocated negative goodwill	—	—	5,445,670
Net income	$ 40,214,722	$ 36,949,497	$ 31,614,269
Basic earnings per common share			
Income before extraordinary item	$ 1.61	$ 1.54*	$ 1.12*
Extraordinary item	—	—	0.23*
Net income	$ 1.61	$ 1.54*	$ 1.35*
Diluted earnings per common share			
Income before extraordinary item	$ 1.57	$ 1.49*	$ 1.08*
Extraordinary item	—	—	.23*
Net income	$ 1.57	$ 1.49*	$ 1.31*
Statements of Comprehensive Income			
Net income	$ 40,214,722	$ 36,949,497	$ 31,614,269
Other comprehensive income (loss), net of tax			
Unrealized gains (losses) on securities:			
Unrealized holding gain (loss) arising during the period, net of income tax (benefit) of $2,002,163, ($563,267) and $221,920	3,718,301	(1,046,066)	412,085
Reclassification adjustment for gains included in net income, net of income tax of $640,339, $630,983 and $513,177	(1,189,200)	(1,171,826)	(953,043)
Other comprehensive income (loss)	2,529,101	(2,217,892)	(540,958)
Comprehensive income	$ 42,743,823	$ 34,731,605	$ 31,073,311

* All 2005 and 2004 per share information has been restated for a 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Stockholders' Equity

	Common Stock				Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
	Class A Shares	Class B Shares	Class A Amount	Class B Amount					
Balance, January 1, 2004*	17,564,345	5,425,009	$ 175,645	$ 54,251	$122,744,905	$ 5,290,923	$ 81,275,256	$(891,748)	$208,649,232
Issuance of common stock	86,643	503	867	4	859,945				860,816
Net income							31,614,269		31,614,269
Cash dividends							(6,177,713)		(6,177,713)
Exercise of stock options	828,417	222,839	8,284	2,229	6,081,938				6,092,451
Grant of stock options					87,259		(87,259)		—
Tax benefit on exercise of stock options					2,206,217				2,206,217
Other comprehensive loss						(540,958)			(540,958)
Balance, December 31, 2004*	18,479,405	5,648,351	$ 184,796	$ 56,484	$131,980,264	$ 4,749,965	$106,624,553	$(891,748)	$242,704,314
Issuance of common stock	84,168		841		1,149,992				1,150,833
Net income							36,949,497		36,949,497
Cash dividends							(7,029,234)		(7,029,234)
Exercise of stock options	592,596	889	5,925	8	4,395,808				4,401,741
Grant of stock options					2,469,963		(2,469,963)		—
Tax benefit on exercise of stock options					1,936,927				1,936,927
Other comprehensive loss						(2,217,892)			(2,217,892)
Balance, December 31, 2005*	19,156,169	5,649,240	$ 191,562	$ 56,492	$141,932,954	$ 2,532,073	$134,074,853	$(891,748)	$277,896,186
Issuance of common stock	76,211		761		1,613,975				1,614,736
Net income							40,214,722		40,214,722
Cash dividends							(8,444,349)		(8,444,349)
Exercise of stock options	601,868		6,019		4,686,982				4,693,001
Grant of stock options					1,858,525		(1,858,525)		—
Tax benefit on exercise of stock options					2,298,865				2,298,865
Other comprehensive income						2,529,101			2,529,101
Balance, December 31, 2006	19,834,248	5,649,240	$ 198,342	$ 56,492	$152,391,301	$ 5,061,174	$163,986,701	$(891,748)	$320,802,262

***** All 2005 and 2004 capital accounts and share information have been restated for a 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Cash Flows

Year Ended December 31,	2006	2005	2004
Cash Flows from Operating Activities:			
Net income	$ 40,214,722	$ 36,949,497	$ 31,614,269
Adjustments to reconcile net income to net cash provided by operating activities:			
Extraordinary gain — unallocated negative goodwill	—	—	(5,445,670)
Depreciation and amortization	2,714,863	3,066,227	2,472,813
Net realized investment gains	(1,829,539)	(1,802,809)	(1,466,220)
Changes in Assets and Liabilities:			
Losses and loss expenses	(6,707,068)	(1,460,533)	13,353,426
Unearned premiums	10,242,922	12,201,627	20,002,138
Accrued expenses	47,527	(707,033)	2,406,540
Premiums receivable	(2,824,348)	(2,857,425)	(6,638,081)
Deferred policy acquisition costs	(1,262,336)	(1,218,833)	(6,033,995)
Deferred income taxes	1,085,320	583,857	(405,256)
Reinsurance receivable	(3,539,919)	4,341,561	(9,402,114)
Accrued investment income	(247,752)	(560,162)	(503,171)
Amounts due to/from affiliate	838,605	487,806	(663,772)
Reinsurance balances payable	220,680	97,920	(576,711)
Prepaid reinsurance premiums	(4,313,815)	(4,155,762)	(2,558,204)
Current income taxes	(97,444)	4,504,092	(1,852,097)
Other, net	(791,245)	(538,492)	(306,822)
Net adjustments	(6,463,549)	11,982,041	2,382,804
Net cash provided by operating activities	33,751,173	48,931,538	33,997,073
Cash Flows from Investing Activities:			
Purchase of fixed maturities			
Held to maturity	—	(9,747,396)	(64,920,048)
Available for sale	(86,959,685)	(144,354,178)	(75,037,253)
Purchase of equity securities	(24,061,899)	(21,643,113)	(20,631,815)
Sale of fixed maturities			
Held to maturity	—	860,000	—
Available for sale	18,143,309	46,928,296	27,813,196
Maturity of fixed maturities			
Held to maturity	10,281,460	10,403,050	21,446,791
Available for sale	34,133,752	23,951,015	53,944,121
Sale of equity securities	22,312,085	26,329,709	14,924,971
Purchase of Le Mars Insurance Company (net of cash acquired)	—	—	(11,816,523)
Purchase of Peninsula Insurance Group (net of cash acquired)	—	—	(21,912,629)
Net decrease (increase) in investment in affiliates	(23,343)	52,781	(2,222,872)
Net purchase of property and equipment	(848,719)	(703,600)	(521,095)
Net sales (purchases) of short-term investments	(10,831,206)	16,714,841	40,259,336
Net cash used in investing activities	(37,854,246)	(51,208,595)	(38,673,820)
Cash Flows from Financing Activities:			
Issuance of common stock	6,307,737	5,550,881	6,948,287
Issuance of subordinated debentures	—	—	5,155,000
Cash dividends paid	(7,782,784)	(6,813,143)	(5,984,731)
Tax benefit on exercise of stock options	2,298,865	—	—
Net cash provided by (used in) financing activities	823,818	(1,262,262)	6,118,556
Net increase (decrease) in cash	(3,279,255)	(3,539,319)	1,441,809
Cash at beginning of year	3,811,011	7,350,330	5,908,521
Cash at end of year	$ 531,756	$ 3,811,011	$ 7,350,330

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1 — Summary of Significant Accounting Policies

Organization and Business

We were organized an insurance holding company by Donegal Mutual Insurance Company ("Donegal Mutual") on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Le Mars Insurance Company ("Le Mars") and the Peninsula Insurance Group ("Peninsula"), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in the Mid-Atlantic, Midwest and Southern states. We have three operating segments: the investment function, the personal lines function and the commercial lines function. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies.

At December 31, 2006, Donegal Mutual held approximately 41% of our outstanding Class A common stock and approximately 69% of our outstanding Class B common stock. The operations of our insurance subsidiaries are interrelated with the operations of Donegal Mutual and, while maintaining the separate corporate existence of each company, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

Atlantic States, our largest subsidiary, participates in a pooling agreement with Donegal Mutual. Under the pooling agreement, the insurance business of the two companies is pooled, and Atlantic States assumes 70% of the pooled business. We do not anticipate any changes in the pooling agreement with Donegal Mutual, including changes in Atlantic States' pool participation level in the foreseeable future. The risk profiles of the business written by Atlantic States and Donegal Mutual historically have been, and continue to be, substantially similar. The products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries are determined and administered by the same management and underwriting personnel. In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products marketed by our insurance subsidiaries and Donegal Mutual are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the pool and each company shares the results according to its participation level, Atlantic States realizes 70% of the underwriting profitability of the pool (because of its 70% participation in the pool), while Donegal Mutual realizes 30% of the underwriting profitability of the pool (because of Donegal Mutual's 30% participation in the pool). Pooled business represents the predominant percentage of the net underwriting activity of both Donegal Mutual and Atlantic States. See Note 3 — Transactions with Affiliates for more information regarding the pooling agreement.

We also own 48.2% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a thrift holding company that owns Province Bank FSB. The remaining 51.8% of the outstanding stock of DFSC is owned by Donegal Mutual.

On September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, "Shelby"), part of Vesta Insurance Group, Inc. The agreement granted those members the right, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby's personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby's plans of withdrawal from those three states. As part of the agreement, those members paid specified amounts to Shelby based on the direct premiums written by those members on the renewal and replacement policies they issued. Net premiums written related to this agreement amounted to $4.8 million in 2006 and $0 in 2005.

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 terms "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 insurance subsidiaries' reserves for property and casualty insurance unpaid losses and loss expenses, valuation of investments and our insurance subsidiaries' policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the estimates provided. The methods for making these estimates are regularly reviewed, and any adjustment considered necessary is reflected in our current results of operations.

Reclassification

Certain amounts in 2005 and 2004 as reported in the Consolidated Balance Sheets, Consolidated Statements of Cash Flows and Notes to Consolidated Financial Statements have been reclassified to conform to the current year presentation. The capital stock accounts, all share amounts and earnings per share amounts for 2005 and 2004 have been restated to reflect the four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33 1/3 % stock dividend to stockholders of record at the close of business April 17, 2006 and paid on April 26, 2006.

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.

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. When determining possible impairment of our debt securities, we consider unrealized losses that are due to the impact of higher market interest rates to be temporary in nature because we have the ability and intent to hold our debt securities to recovery.

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.

Investments in affiliates are accounted for using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock." Under the equity method, we record our investment at cost, with adjustments for our share of affiliate earnings and losses as well as changes in affiliate equity due to unrealized gains and losses.

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.

Subordinated Debentures — The carrying amounts reported in the balance sheet for these instruments approximate fair value due to their variable rate nature.

Revenue Recognition

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

Policy Acquisition Costs

Our insurance subsidiaries' 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. Estimates in the calculation of policy acquisition costs have not shown material variability because of uncertainties in applying accounting principles or as a result of sensitivities to changes in key assumptions.

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

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

Our insurance subsidiaries maintain liabilities for the 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. Our insurance subsidiaries 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. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends, and reviews of historical reserving results. Our insurance subsidiaries closely monitor

their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries' liabilities for losses are not discounted.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions as to our insurance subsidiaries'

internal operations. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and stability in economic conditions and the rate of loss cost inflation. For example, our insurance subsidiaries have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in the recording of claims, payment and closure rates and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectibility of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded.

Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite. Our insurance subsidiaries' personal lines products include standard and preferred risks in private passenger automobile and homeowners lines. Our insurance subsidiaries' commercial lines products primarily include mercantile risks, business offices, wholesalers, service providers and artisan risks, avoiding industrial and manufacturing exposures. Our insurance subsidiaries have limited exposure to asbestos and other environmental liabilities. Our insurance subsidiaries write no medical malpractice or professional liability risks.

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

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, short-term investments is 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 an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the amount that any one security can constitute of our total investment portfolio.

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

Our insurance subsidiaries have reinsurance agreements in place with Donegal Mutual 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

Our insurance subsidiaries rely upon reinsurance agreements to limit their maximum net loss from large single risks or risks in concentrated areas, and to increase their 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, our insurance subsidiaries are exposed to the risk of continued liability for such losses. However, in an effort to reduce the risk of non-payment, our insurance subsidiaries require all of their 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. All reinsurance transactions are recorded in a manner consistent with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 113, "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts." See Note 10 — Reinsurance for more information regarding our reinsurance agreements.

Stock-Based Compensation

Effective January 1, 2006, we adopted SFAS No. 123(R), "Share-Based Payment," superseding Accounting Principles Board (APB) Opinion No. 25. SFAS No. 123(R) requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income.

SFAS No. 123(R) does not set accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to nonemployees under the provisions of FASB Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions involving Stock Compensation," and Emerging Issues Task Force Issue No. 00-23 (EITF 00-23), "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25, Accounting for Stock Issued to Employees, and FIN No. 44, Accounting for Certain Transactions involving Stock Compensation." Pursuant to FIN No. 44, APB Opinion No. 25 did not apply to the separate financial statements of a subsidiary in accounting for share-based compensation granted by the subsidiary to employees of the parent or another subsidiary. EITF 00-23 states that when employees of a controlling entity are granted share-based compensation, the entity granting the share-based compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to us, because Donegal Mutual is the employer of record for the majority of employees that provide services to us. As a result, the impact of the implementation of SFAS No. 123(R) was not material to our results of operations for the year ended December 31, 2006.

SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous rules. Tax benefits realized upon the exercise of stock options of $2.3 million for the year ended December 31, 2006 were classified as financing activities in our consolidated statements of cash flows.

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 — Impact of New Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the impact of adopting FIN No. 48 to have a significant effect on our results of operation, financial condition or liquidity.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108 to address diversity in practice in quantifying financial statement misstatements. SAB No. 108 requires that registrants quantify the impact on the current year's financial statements of correcting all misstatements, including the carryover and reversing effects of prior years' misstatements, as well as the effects of errors arising in the current year. SAB No. 108 is effective as of the first fiscal year ending after November 15, 2006, allowing a one-time transitional cumulative effect adjustment to retained earnings as of January 1, 2006, for errors that were not previously deemed material, but are material under the guidance in SAB No. 108. We do not expect the provisions of SAB No. 108 to have a significant effect on our results of operations, financial condition or liquidity.

3 — Transactions with Affiliates

Our insurance subsidiaries conduct business and have various agreements with Donegal Mutual that are described below:

a. Reinsurance Pooling and Other Reinsurance Arrangements

Atlantic States, our largest subsidiary, and Donegal Mutual have a pooling agreement under which both companies contribute all of their direct written business to the pool and are allocated a given percentage of their combined underwriting results, excluding certain reinsurance assumed by Donegal Mutual from our insurance subsidiaries. Atlantic States has a 70% share of the results of the pool, and Donegal Mutual 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.

The following amounts represent ceded reinsurance transactions related to the pooling agreement during 2006, 2005 and 2004:

	2006	2005	2004
Premiums earned	$76,945,746	$72,448,322	$62,831,701
Losses and loss expenses	$37,552,309	$42,221,699	$42,487,082
Prepaid reinsurance premiums	$42,311,034	$38,295,662	$34,227,955
Liability for losses and loss expenses	$50,769,807	$56,024,073	$57,989,162

The following amounts represent assumed reinsurance transactions related to the pooling agreement for 2006, 2005 and 2004:

	2006	2005	2004
Premiums earned	$187,590,899	$181,979,294	$167,949,892
Losses and loss expenses	$100,804,383	$102,928,483	$101,567,995
Unearned premiums	$ 95,121,169	$ 90,357,498	$ 84,350,320
Liability for losses and loss expenses	$122,491,281	$128,428,653	$127,127,611

Effective October 1, 2005, Donegal Mutual entered into a quota-share reinsurance agreement with Southern whereby Southern assumes 100% of the premiums and losses related to personal lines products offered in Virginia by Donegal Mutual through the use of its automated policy quoting and issuance system. The following amounts represent assumed reinsurance transactions related to the quota-share reinsurance agreement for 2006, 2005 and 2004:

	2006	2005	2004
Premiums earned	$1,522,593	$ 22,392	$—
Losses and loss expenses	$ 621,216	$ —	$—
Unearned premiums	$1,770,965	$158,729	$—
Liability for losses and loss expenses	$ 113,838	$ —	$—

Effective August 1, 2005, Donegal Mutual entered into a quota-share reinsurance agreement with Peninsula whereby Donegal Mutual assumes 100% of the premiums and losses related to the Pennsylvania workers' compensation product line of Peninsula Indemnity Company. Prior to January 1, 2002, Donegal Mutual and Southern had a quota-share agreement whereby Southern ceded 50% of its direct business, less reinsurance, to Donegal Mutual. The business assumed by Donegal Mutual becomes part of the pooling agreement between Donegal Mutual and Atlantic States. The following amounts represent ceded reinsurance transactions related to the quota-share reinsurance agreements for 2006, 2005 and 2004:

	2006	2005	2004
Premiums earned	$ 44,815	$ 6,576	$ —
Losses and loss expenses	$ (162,935)	$ (264,275)	$ (611,479)
Prepaid reinsurance premiums	$ 233,327	$ 36,475	$ —
Liability for losses and loss expenses	$1,213,874	$1,331,482	$2,333,521

Atlantic States, Southern and Le Mars each have a catastrophe reinsurance agreement with Donegal Mutual that limits the maximum liability under any one catastrophic occurrence to $800,000, $600,000 and $500,000, respectively, with a combined limit of $1,500,000 for a catastrophe involving a combination of these subsidiaries. Donegal Mutual and Southern have an excess of loss reinsurance agreement in which Donegal Mutual assumes up to $150,000 ($260,000 in 2005 and $170,000 in 2004) of losses in excess of $250,000 ($200,000 in 2005 and 2004). Through December 31, 2006, Donegal Mutual had an agreement in place with Southern to reallocate the loss results of workers' compensation business written by Southern as part of commercial accounts primarily written by Donegal Mutual or Atlantic States. This agreement provided for the workers' compensation loss ratio of

Southern to be no worse than the average workers' compensation loss ratio for Atlantic States, Southern and Donegal Mutual combined. The following amounts represent ceded reinsurance transactions related to these reinsurance agreements during 2006, 2005 and 2004:

	2006	2005	2004
Premiums earned	$5,413,937	$5,318,619	$4,344,867
Losses and loss expenses	$1,283,114	$ 686,827	$4,583,270
Liability for losses and loss expenses	$4,083,733	$5,057,471	$7,532,812

The following amounts represent the effect of affiliated reinsurance transactions on net premiums earned during 2006, 2005 and 2004:

	2006	2005	2004
Assumed	$189,113,492	$182,001,686	$167,949,892
Ceded	(82,404,498)	(77,773,517)	(67,176,568)
Net	$106,708,994	$104,228,169	$100,773,324

The following amounts represent the effect of affiliated reinsurance transactions on net losses and loss expenses during 2006, 2005 and 2004:

	2006	2005	2004
Assumed	$101,425,599	$102,928,483	$101,567,995
Ceded	(38,672,488)	(42,644,251)	(46,458,873)
Net	$ 62,753,111	$ 60,284,232	$ 55,109,122

In addition to the reinsurance agreements described above, Southern and Le Mars (effective April 1, 2004) have agreements with Donegal Mutual under which they cede, and then reassume back, 100% of their business net of reinsurance. The primary purpose of these agreements is to provide Southern and Le Mars with the same A.M. Best rating (currently "A") as Donegal Mutual, which these subsidiaries might not achieve without these agreements in place. These agreements do not transfer insurance risk. While these subsidiaries ceded and reassumed amounts received from policyholders of $78,554,596, $75,542,412 and $64,696,278 and claims of $39,876,504, $38,529,733 and $36,269,291 under these agreements in 2006, 2005 and 2004, respectively, the amounts are not reflected in our consolidated financial statements. The aggregate liabilities ceded and reassumed under these agreements were $72,655,601 and $73,683,929 at December 31, 2006 and 2005, respectively.

b. Expense Sharing

Donegal Mutual provides facilities, management and other services to us and our insurance subsidiaries, and we and our insurance subsidiaries reimburse Donegal Mutual for such services on a periodic basis under usage agreements and pooling arrangements. The charges are primarily based upon the relative participation of Atlantic States and Donegal Mutual in the pooling arrangement, and our management and the management of Donegal Mutual consider this allocation to be reasonable. Charges for these services totalled $48,828,587, $47,025,782 and $40,165,744 for 2006, 2005 and 2004, respectively.

c. Lease Agreement

We lease office equipment and automobiles with terms ranging from 3 to 10 years to Donegal Mutual 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 of our insurance subsidiaries arising in Lancaster, Dauphin and York counties. Such firm is paid its customary fees for such services.

e. Province Bank

As of December 31, 2006 and 2005, we had ($257,101) and $2,479,613, respectively, in checking accounts with Province Bank, a wholly owned subsidiary of DFSC. We earned $179,674, $99,610 and $32,138 in interest on these accounts during 2006, 2005 and 2004, respectively.

4 — Business Combinations

During 2004, we acquired all of the outstanding stock of Le Mars and Peninsula. These acquisitions have been accounted for as business combinations in accordance with SFAS No. 141, "Business Combinations."

In June 2002, Donegal Mutual consummated an affiliation with Le Mars. As part of the affiliation, Donegal Mutual entered into a services 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 all of the outstanding stock of Le Mars as of January 1, 2004 for approximately $12.9 million in cash, including payment of the principal amount of the surplus note ($4.0 million) and accrued interest ($392,740) to Donegal Mutual. The operating results of Le Mars have been included in our consolidated financial statements since January 1, 2004.

The acquisition of Le Mars enables us to conduct our insurance business in four Midwest states. 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. The purchase price of Le Mars was based upon an independent valuation as of July 31, 2003. In applying GAAP purchase accounting standards as of January 1, 2004, we recognized an extraordinary gain in the amount of $5.4 million related to unallocated negative goodwill resulting from this acquisition. A substantial portion of this unallocated negative goodwill was generated by the recognition of anticipated federal income tax benefits that we expect to realize over the allowable 20-year carryover period by offsetting the net operating loss carryover obtained as part of the acquisition of Le Mars against taxable income generated by our consolidated affiliates. We have determined that a valuation allowance is required for a portion of the acquired net operating loss carryover, because federal tax laws limit the amount of such carryover that can be utilized. Other factors that generated negative goodwill included favorable operating results and increases in the market values of invested assets in the period between the valuation date and the acquisition date.

As of January 1, 2004, we purchased all of the outstanding stock of 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. ("Folksamerica"), 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 $23.5 million. The operating results of Peninsula have been included in our consolidated financial statements since January 1, 2004.

Peninsula expands the presence of our insurance subsidiaries in existing markets, operating primarily in Maryland, Delaware and Virginia. Peninsula specializes in private passenger automobile coverages and also writes homeowners, commercial multi-peril, workers' compensation and commercial automobile coverages. We recorded goodwill of $449,968 related to this acquisition, none of which is expected to be deductible for federal income tax purposes. Pursuant to the terms of the purchase agreement with Folksamerica, Folksamerica has guaranteed us against any deficiency in excess of $1.5 million in the loss and loss expense reserves of Peninsula as of January 1, 2004. Any such deficiency will be based on a final actuarial review of the development of such reserves to be conducted four years after January 1, 2004. The maximum obligation of Folksamerica to us under this guarantee is $4.0 million.

5 — Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2006 and 2005, are as follows:

2006				
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	$ 58,094,402	$ —	$1,530,119	$ 56,564,283
Obligations of states and political subdivisions	83,282,591	1,137,563	156,639	84,263,515
Corporate securities	14,637,949	240,144	97,186	14,780,907
Mortgage-backed securities	13,163,195	4,710	353,146	12,814,759
Totals	$169,178,137	$1,382,417	$2,137,090	$168,423,464

2006				
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	$ 45,242,994	$ 81,877	$ 489,308	$ 44,835,563
Obligations of states and political subdivisions	213,090,135	2,929,253	501,129	215,518,259
Corporate securities	18,424,936	170,032	119,246	18,475,722
Mortgage-backed securities	53,677,246	16,408	853,420	52,840,234
Fixed maturities	330,435,311	3,197,570	1,963,103	331,669,778
Equity securities	33,505,531	7,422,443	386,148	40,541,826
Totals	$363,940,842	$10,620,013	$2,349,251	$372,211,604

2005				
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	$ 58,735,488	$ —	$1,869,523	$ 56,865,965
Obligations of states and political subdivisions	84,655,911	1,145,476	338,824	85,462,563
Corporate securities	21,508,436	341,108	399,477	21,450,067
Mortgage-backed securities	15,282,470	25,887	485,825	14,822,532
Totals	$180,182,305	$1,512,471	$3,093,649	$178,601,127

2005				
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	$ 51,374,133	$ 212,379	$ 727,857	$ 50,858,655
Obligations of states and political subdivisions	179,004,037	2,190,981	623,988	180,571,030
Corporate securities	20,328,627	241,579	458,147	20,112,059
Mortgage-backed securities	44,390,432	13,710	848,651	43,555,491
Fixed maturities	295,097,229	2,658,649	2,658,643	295,097,235
Equity securities	28,993,361	4,763,905	385,906	33,371,360
Totals	$324,090,590	$7,422,554	$3,044,549	$328,468,595

The amortized cost and estimated fair value of fixed maturities at December 31, 2006, 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	$ 10,873,432	$ 10,764,755
Due after one year through five years	59,982,055	58,784,265
Due after five years through ten years	56,158,392	56,997,995
Due after ten years	29,001,063	29,061,690
Mortgage-backed securities	13,163,195	12,814,759
Total held to maturity	$169,178,137	$168,423,464
Available for sale		
Due in one year or less	$ 20,713,940	$ 20,607,989
Due after one year through five years	51,873,365	51,938,988

Due after five years through ten years	114,622,676	115,420,716
Due after ten years	89,548,084	90,861,851
Mortgage-backed securities	53,677,246	52,840,234
Total available for sale	$330,435,311	$331,669,778

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2006 and 2005 amounted to $8,995,600 and $9,043,786, respectively.

Investments in affiliates consisted of the following at December 31, 2006 and 2005:

	2006	2005
DFSC	$7,534,059	$7,512,546
Other	929,000	929,000
Total	$8,463,059	$8,441,546

We made an additional equity investment in DFSC in the amount of $200,000 during 2006. Other expenses in our consolidated statements of income include $176,657, $52,781 and $182,128 for 2006, 2005 and 2004, respectively, representing our share of DFSC losses. In addition, other comprehensive income (loss) in our statements of comprehensive income includes net unrealized losses of $1,189, $240,769 and $62,366 for 2006, 2005 and 2004, respectively, representing our share of DFSC unrealized investment losses.

Other investment in affiliates represents our investment in statutory trusts that hold our subordinated debentures as discussed in Note 9.

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

	2006	2005	2004
Fixed maturities	$20,557,402	$18,574,964	$16,540,611
Equity securities	992,139	975,420	989,966
Short-term investments	1,805,082	966,416	524,172
Other	34,180	34,853	30,770
Investment income	23,388,803	20,551,653	18,085,519
Investment expenses	(2,068,722)	(2,079,690)	(2,178,791)
Net investment income	$21,320,081	$18,471,963	$15,906,728

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:

	2006	2005	2004
Gross realized gains:			
Fixed maturities	$ 128,395	$ 674,585	$ 458,389
Equity securities	2,482,396	2,970,215	1,252,075
	2,610,791	3,644,800	1,710,464
Gross realized losses:			
Fixed maturities	492,968	805,183	35,952
Equity securities	288,284	1,036,808	208,292
	781,252	1,841,991	244,244
Net realized gains	$1,829,539	$ 1,802,809	$ 1,466,220
Change in difference between fair value and cost of investments:			
Fixed maturities	$2,060,966	$(8,381,388)	$(2,617,967)
Equity securities	2,658,296	1,643,782	914,179
	$4,719,262	$(6,737,606)	$(1,703,788)

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2006 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	$10,921,320	$ 30,528	$ 78,616,562	$1,988,899
Obligations of states and political subdivisions	18,707,294	130,414	51,184,920	527,354
Corporate securities	3,004,951	2,348	10,764,265	214,084
Mortgage-backed securities	18,357,290	170,036	37,910,625	1,036,530
Equity securities	6,107,135	310,273	902,033	75,875
Totals	$57,277,990	$643,599	$179,378,405	$3,842,742

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2005 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	$ 32,943,116	$ 641,545	$62,590,126	$1,955,835
Obligations of states and political subdivisions	73,457,810	906,530	6,586,927	56,282
Corporate securities	11,090,482	475,516	5,864,581	382,108
Mortgage-backed securities	36,270,000	785,018	13,836,649	549,458
Equity securities	3,715,877	240,474	1,178,209	145,432
Totals	$157,477,285	$3,049,083	$90,056,492	$3,089,115

The unrealized losses in our fixed maturities were primarily due to the impact of higher market interest rates rather than a decline in credit quality. We consider such unrealized losses to be temporary in nature because we have the ability and intent to hold our fixed maturities to recovery.

During 2006, 2005 and 2004, certain investments trading below cost had declined on an other than temporary basis. Losses of $47,538, $409,432 and $6,650 were included in net realized investment gains for these investments in 2006, 2005 and 2004, respectively.

During 2005, we sold bonds that had been classified as held to maturity due to significant deterioration in the issuer's creditworthiness. These bonds had an amortized cost of $1.0 million, and the sale resulted in a realized loss of $144,047. There were no other sales or transfers from the held to maturity portfolio in 2006, 2005 or 2004.

We have no derivative instruments or hedging activities.

6 — Deferred Policy Acquisition Costs

Changes in our insurance subsidiaries' deferred policy acquisition costs are as follows:

	2006	2005	2004
Balance, January 1	$ 23,476,593	$ 22,257,760	$ 16,223,765
Acquisition costs deferred	49,857,336	48,452,833	45,467,995
Amortization charged to earnings	(48,595,000)	(47,234,000)	(39,434,000)
Balance, December 31	$ 24,738,929	$ 23,476,593	$ 22,257,760

7 — Property and Equipment

Property and equipment at December 31, 2006 and 2005 consisted of the following:

	2006	2005	Estimated Useful Life
Office equipment	$ 6,682,835	$ 6,483,921	5-15 years
Automobiles	1,459,361	1,216,085	3 years
Real estate	3,908,506	3,893,293	15-50 years
Software	605,262	573,672	5 years
	12,655,964	12,166,971	
Accumulated depreciation	(7,509,659)	(6,932,548)	
	$ 5,146,305	$ 5,234,423	

Depreciation expense for 2006, 2005 and 2004 amounted to $936,837, $984,946 and $932,987, respectively.

8 — Liability for Losses and Loss Expenses

The establishment of an appropriate liability for losses and loss expenses is an inherently uncertain process, and there can be no assurance that our insurance subsidiaries' ultimate liability will not exceed their loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities cannot be predicted, since the historical conditions and events that serve as a basis for their estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods our insurance subsidiaries' estimates have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimate of the liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. Activity in our insurance subsidiaries' liability for losses and loss expenses is summarized as follows:

	2006	2005	2004
Balance at January 1	$265,729,527	$267,190,060	$ 217,914,057
Less reinsurance recoverable	(92,720,643)	(95,759,493)	((79,017,987)
Net balance at January 1	173,008,884	171,430,567	138,896,070
Acquisitions of Le Mars and Peninsula	—	—	28,843,140
Net balance at January 1 as adjusted	173,008,884	171,430,567	167,739,210
Incurred related to:			
Current year	182,037,189	176,924,029	171,384,964
Prior years	(13,615,764)	(9,382,132)	(7,243,596)
Total incurred	168,421,425	167,541,897	164,141,368
Paid related to:			
Current year	106,400,754	98,734,594	96,041,306
Prior years	71,717,592	67,228,986	64,408,705
Total paid	178,118,346	165,963,580	160,450,011
Net balance at December 31	163,311,963	173,008,884	171,430,567
Plus reinsurance recoverable	95,710,496	92,720,643	95,759,493
Balance at December 31	$259,022,459	$265,729,527	$ 267,190,060

Our insurance subsidiaries recognized a decrease in the liability for losses and loss expenses of prior years of $13.6 million, $9.4 million and $7.2 million in 2006, 2005 and 2004, respectively. Generally, our insurance subsidiaries experienced improving loss development trends during these years, which were reflected in favorable settlements of open claims. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management during these years, even though they reflected changes in their reserve estimates in these years. No significant offsetting changes in estimates increased or decreased our insurance subsidiaries' loss and loss expense reserves in these years. The 2006 development was primarily recognized in the workers' compensation, private passenger automobile liability and commercial multi-peril lines of business and was consistently favorable for settlements of claims occurring in each of the previous five accident years. The majority of the 2006 development was related to decreases in the liability for losses and loss expenses of prior years of Atlantic States.

9 — 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. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2006, we may borrow up to $35.0 million at interest rates equal to M&T's current prime rate or the then current London Interbank Eurodollar bank rate (LIBOR) 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 credit 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 insurance subsidiaries. During the years ended December 31, 2006 and 2005, no borrowings were outstanding, and we complied with all requirements of the credit agreement.

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, 2006, the interest rate on these debentures was 9.47%, and is next subject to adjustment on February 15, 2007. As of December 31, 2006 and 2005, our consolidated balance sheets included an investment in a trust of $464,000 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, 2006, the interest rate on these debentures was 9.23%, and is next subject to adjustment on January 29, 2007. As of December 31, 2006 and 2005, our consolidated balance sheets included an investment in a trust of $310,000 and subordinated debentures of $10.3 million related to this transaction.

On May 24, 2004, we received $5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 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, 2006, the interest rate on these debentures was 9.22%, and is next subject to adjustment on February 24, 2007. As of December 31, 2006 and 2005, our consolidated balance sheets included an investment in a trust of $155,000 and subordinated debentures of $5.2 million related to this transaction.

10 — Reinsurance

Unaffiliated Reinsurers

Atlantic States, Southern and Donegal Mutual purchase third-party reinsurance on a combined basis. Le Mars and Peninsula have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with their 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 management, is equivalent to a company with at least an A-rating. The external reinsurance Atlantic States, Southern and Donegal Mutual purchase includes “excess of loss reinsurance,” under which their losses are automatically reinsured, through a series of contracts, over a set retention ($400,000), and “catastrophic reinsurance,” under which they recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention ($3.0 million). Our insurance subsidiaries’ principal third party reinsurance agreement in 2006 was a multi-line per risk excess of loss treaty that provided 100% coverage up to $1.0 million for both property and liability losses over the set retention. For property insurance, our insurance subsidiaries also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $2.5 million per loss. For liability insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $40.0 million per occurrence. For workers’ compensation insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $5.0 million on any one life. Atlantic States, Southern and Donegal Mutual had property catastrophe coverage through a series of layered treaties up to aggregate losses of $80.0 million for any single event. This coverage was provided through as many as 26 reinsurers on any one treaty with no reinsurer taking more than 22.5% of any one contract. The amount of coverage provided under each of these types of reinsurance depended upon the amount, nature, size and location of the risks being reinsured. Donegal Mutual and our insurance subsidiaries also purchased facultative reinsurance to cover exposures from losses that exceeded the limits provided by our respective treaty reinsurance. The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers during 2006, 2005 and 2004:

	2006	2005	2004
Premiums written	$21,820,998	$19,655,767	$22,016,464
Premiums earned	$21,719,407	$19,604,187	$23,704,363
Losses and loss expenses	$20,158,275	$ 9,886,287	$14,324,616
Prepaid reinsurance premiums	$ 1,832,592	$ 1,731,001	$ 1,679,421
Liability for losses and loss expenses	$39,643,082	$31,176,231	$27,903,998

Total Reinsurance

The following amounts represent the total of all ceded reinsurance transactions with both affiliated and unaffiliated reinsurers during 2006, 2005 and 2004:

	2006	2005	2004
Premiums earned	$104,123,905	$97,377,704	$90,880,931
Losses and loss expenses	$ 58,830,763	$52,530,538	$60,783,489
Prepaid reinsurance premiums	$ 44,376,953	$40,063,138	$35,907,376
Liability for losses and loss expenses	$ 95,710,496	$93,589,257	$95,759,493

The following amounts represent the effect of reinsurance on premiums written during 2006, 2005 and 2004:

	2006	2005	2004
Direct	$ 220,192,787	$ 215,719,476	$202,064,323
Assumed	195,652,202	188,357,878	174,657,504
Ceded	(108,437,720)	(101,533,466)	(93,439,390)
Net premiums written	$ 307,407,269	$ 302,543,888	$283,282,437

The following amounts represent the effect of reinsurance on premiums earned during 2006, 2005 and 2004:

	2006	2005	2004
Direct	$ 216,319,824	$209,693,968	$188,665,453
Assumed	189,282,243	182,181,759	168,054,072
Ceded	(104,123,905)	(97,377,704)	(90,880,931)
Net premiums earned	$ 301,478,162	$294,498,023	$265,838,594

11 — Income Taxes

The provision for income tax consists of the following:

	2006	2005	2004
Current	$15,322,221	$14,812,141	$11,290,908
Deferred	1,085,320	583,857	(405,256)
Federal tax provision	$16,407,541	$15,395,998	$10,885,652

The effective tax rate is different from the amount computed at the statutory federal rate of 35% for 2006, 2005 and 2004. The reasons for such difference and the related tax effects are as follows:

	2006	2005	2004
Income before income taxes	$56,622,263	$52,345,495	$37,054,251
Computed “expected” taxes	19,817,792	18,320,923	12,968,988
Tax-exempt interest	(3,929,188)	(3,350,307)	(2,302,247)
Dividends received deduction	(118,060)	(98,203)	(106,836)
Other, net	636,997	523,585	325,747
Federal income tax provision	$16,407,541	$15,395,998	$10,885,652

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2006 and 2005 are as follows:

	2006	2005
Deferred tax assets:		
Unearned premium	$10,688,614	$10,270,793
Loss reserves	5,728,904	6,551,470
Net operating loss carryforward - acquired companies	3,929,268	4,376,784
Other	1,278,780	1,178,323
Total gross deferred assets	21,625,566	22,377,370
Less valuation allowance	(770,799)	(770,799)
Net deferred tax assets	20,854,767	21,606,571
Deferred tax liabilities:		
Depreciation expense	188,035	280,477
Deferred policy acquisition costs	8,658,625	8,216,807
Salvage recoverable	197,171	213,031
Net unrealized gains	2,725,248	1,363,422
Total gross deferred liabilities	11,769,079	10,073,737
Net deferred tax asset	$ 9,085,688	$11,532,834

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 a valuation allowance of $770,799 related to a portion of the net operating loss carryforward of Le Mars should be established at January 1, 2004. Management has determined that it is not required to establish a valuation allowance for the other net deferred tax assets of $20,854,767 and $21,606,571 at December 31, 2006 and 2005, respectively, since it is more likely than not that the deferred tax assets will be realized through reversals of existing temporary differences, future taxable income, carrybacks to taxable income in prior years and the implementation of tax planning strategies.

At December 31, 2006, we have a net operating loss carryforward of $10.5 million, which is available to offset our taxable income. Of this amount, $9.0 million will begin to expire in 2009 and is subject to an annual limitation in the amount that we can use in any one year of approximately $376,000. The remaining $1.5 million will expire in 2012 and is subject to an annual limitation of approximately $903,000.

12 — 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 of directors 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 on April 19, 2001.

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.

On February 17, 2005, our board of directors approved a four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33 1/3% stock dividend to stockholders of record at the close of business on March 1, 2005 and paid on March 28, 2005.

On April 6, 2006, our board of directors approved a four-for-three stock split of our Class A common stock and our Class B common stock effected in the form of a 33$^{1}/_{3}$% stock dividend to stockholders of record at the close of business on April 17, 2006 and paid on April 26, 2006.

13 — Stock Compensation Plans

Equity Incentive Plans

During 1996, we adopted an equity incentive plan for employees. During 2001, we adopted a nearly identical plan that made a total of 2,666,667 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. During 2005, an amendment to the plan made a total of 4,000,000 shares of Class A common stock available for issuance. Each plan provides for the granting of awards by our 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. 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 355,556 shares of Class A common stock available for issuance to our directors and those of our subsidiaries and affiliates. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 311 shares of restricted stock to each director on the first business day of January in each year. As of December 31, 2006, we have 238,666 unexercised options under these plans. Additionally 3,417, 3,733 and 3,423 shares of restricted stock were issued on January 2, 2006, 2005 and 2004, respectively.

Effective January 1, 2006, we adopted SFAS No. 123 (R), which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. In determining the expense to be recorded for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The significant assumptions utilized in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility.

The weighted-average grant date fair value of options granted during 2006 was $3.05. This fair value was calculated based upon a risk-free interest rate of 5%, expected term of 3 years, expected volatility of 19% and expected dividend yield of 2%.

The weighted-average grant date fair value of options granted during 2005 was $3.27. This fair value was calculated based upon a risk-free interest rate of 4%, expected term of 3 years, expected volatility of 30% and expected dividend yield of 2%.

Under SFAS No. 123(R), the compensation expense for the stock compensation plans that has been charged against income before income taxes was $268,805 for the year ended December 31, 2006, with a corresponding income tax benefit of $94,082. As of December 31, 2006, the Company's total unrecognized compensation cost related to nonvested share-based compensation granted under the plans was $635,401. The cost is expected to be recognized over a weighted average period of 2.4 years.

The following table illustrates the effect on net income and earnings per share as if we had applied the provisions of SFAS No. 123(R) prior to 2006:

	2005	2004
Net income, as reported	$36,949,497	$31,614,269
Less:		
Total stock-based employee compensation expense, net of related tax effect	(66,427)	(18,657)
Pro forma net income	$36,883,070	$31,595,612
Basic earnings per share:		
As reported	$ 1.54	$ 1.35
Pro forma	1.53	1.35
Diluted earnings per share:		
As reported	$ 1.49	$ 1.31
Pro forma	1.49	1.31

SFAS No. 123(R) does not set accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to nonemployees under the provisions of FIN No. 44 and EITF 00-23, which states that when employees of a controlling entity are granted share-based compensation, the entity granting the share-based compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to options granted to employees and directors of Donegal Mutual, the employer of record for the majority of employees that provide services to us. Implied dividends of $1,858,525 and $2,469,963 were recorded for the years ended December 31, 2006 and 2005, respectively.

Cash received from option exercises under all stock compensation plans for the year ended December 31, 2006 was $4,693,001. The actual tax benefit realized for the tax deductions from option exercises of share-based compensation was $2,298,865 for the year ended December 31, 2006.

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 follows:

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2003	2,629,968	$ 6.59
Granted – 2004	61,333	10.60
Exercised – 2004	(1,051,256)	5.80
Forfeited – 2004	(53,045)	6.66
Outstanding at December 31, 2004	1,587,000	7.28
Granted – 2005	1,338,223	15.73
Exercised – 2005	(593,485)	7.42
Forfeited – 2005	(49,631)	15.52
Outstanding at December 31, 2005	2,282,107	12.02
Granted – 2006	1,055,667	20.98
Exercised – 2006	(601,869)	7.80
Forfeited – 2006	(52,078)	14.52
Outstanding at December 31, 2006	2,683,827	$16.44

Exercisable at:

December 31, 2004	1,214,967	$ 7.30
December 31, 2005	981,069	$ 7.13
December 31, 2006	824,681	$11.32

Options available for future grants at December 31, 2006 are 61,168.

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

Exercise Price	Number of Options Outstanding	Weighted-Average Remaining Contractual Life	Number of Options Exercisable
$6.75	398,579	1.5 years	398,579
10.27	8,889	1.5 years	8,889
11.77	3,556	2.5 years	2,371
12.41	4,534	3.5 years	4,534
13.41	8,333	3.0 years	8,333
15.25	8,889	3.5 years	—
15.75	1,182,047	4.5 years	393,976
17.65	4,000	4.5 years	1,333
17.70	13,333	4.5 years	4,444
18.49	2,000	5.5 years	—
21.00	1,043,000	5.5 years	—
21.15	6,667	4.5 years	2,222
Total	2,683,827		824,681

Employee Stock Purchase Plans

During 1996, we adopted an employee stock purchase plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance.

The 2001 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 Class A 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 Class A 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, 2004	$ 6.44	13,577
July 1, 2004	9.57	8,905
January 1, 2005	9.89	10,788
July 1, 2005	10.28	11,445
January 1, 2006	11.77	10,763
July 1, 2006	15.45	9,531

On January 1, 2007, we issued an additional 10,929 shares at a price of $15.02 per share under this plan.

Agency Stock Purchase Plans

During 1996, we adopted an agency stock purchase plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance. The 2001 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 2006, 2005 and 2004, 52,500, 58,201 and 58,349 shares, respectively, were issued under this plan. Expense recognized under the plan was not material.

14 — Statutory Net Income, Capital and Surplus and Dividend Restrictions

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

	2006	2005	2004
Atlantic States			
Statutory capital and surplus	$169,947,815	$148,521,462	$127,219,109
Statutory unassigned surplus	$116,286,951	$ 94,860,598	$ 73,558,245
Statutory net income	$ 26,734,985	$ 21,855,006	$ 16,342,671

	2006	2005	2004
Southern			
Statutory capital and surplus	$ 62,201,936	$ 56,802,771	$ 50,253,802
Statutory unassigned surplus	$ 13,084,350	$ 7,685,185	$ 1,136,217
Statutory net income	$ 5,905,912	$ 5,444,954	$ 2,868,102
Le Mars			
Statutory capital and surplus	$ 25,415,894	$ 21,386,553	$ 17,103,902
Statutory unassigned surplus	$ 12,823,154	$ 8,793,813	$ 4,511,162
Statutory net income	$ 5,096,706	$ 4,293,555	$ 3,268,819

Peninsula

Statutory capital and surplus	$ 33,307,701	$ 29,050,474	$ 23,176,096
Statutory unassigned surplus	$ 15,508,287	$ 11,251,060	$ 5,576,682
Statutory net income	$ 5,295,045	$ 6,165,498	$ 3,781,849

Our principal source of cash for payment of dividends are dividends from our insurance subsidiaries that 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. Our insurance subsidiaries are also subject to Risk Based Capital (RBC) requirements that may further impact their ability to pay dividends. At December 31, 2006, our insurance subsidiaries' 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 2007 are $26,734,985 from Atlantic States, $5,905,912 from Southern, $2,541,589 from Le Mars and $3,330,770 from Peninsula.

15 — Reconciliation of Statutory Filings to Amounts Reported Herein

Our insurance 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 in the United States.

Reconciliations of 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,		
	2006	2005	2004
Statutory net income of insurance subsidiaries	$ 43,032,648	$37,759,013	$26,261,441
Adjustments:			
Deferred policy acquisition costs	1,262,336	1,218,833	6,033,995
Deferred federal income taxes	(1,085,320)	(583,857)	405,256
Salvage and subrogation recoverable	(167,000)	164,306	(112,182)
Consolidating eliminations and adjustments	(10,686,208)	(1,805,579)	(579,343)
Parent-only net income (loss)	7,858,266	196,781	(394,898)
Net income as reported herein	$ 40,214,722	$36,949,497	$31,614,269

	December 31,		
	2006	2005	2004
Statutory capital and surplus of insurance subsidiaries	$290,873,346	$255,761,260	$217,752,909
Adjustments:			
Deferred policy acquisition costs	24,738,929	23,476,593	22,257,760
Deferred federal income taxes	(6,271,094)	(3,751,776)	(3,855,261)
Salvage and subrogation recoverable	8,144,000	8,311,000	8,146,694
Non-admitted assets and other adjustments, net	1,117,248	837,567	1,121,225
Fixed maturities	1,574,902	694,311	6,207,157
Parent-only equity and other adjustments	625,271	(7,432,769)	(8,926,170)
Stockholders’ equity as reported herein	$320,802,602	$277,896,186	$242,704,314

16 — Supplementary Cash Flow Information

The following reflects income taxes and interest paid during 2006, 2005 and 2004:

	2006	2005	2004
Income taxes	$13,125,000	$10,275,000	$12,905,000
Interest	$ 2,755,861	$ 2,191,125	$ 1,528,655

17 — 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, 2006, 2005 and 2004:

	Net Income	Weighted-Average Shares Outstanding	Earnings Per Share
2006:			
Basic	$40,214,722	24,968,439	$1.61
Effect of stock options	—	604,042	(.04)
Diluted	$40,214,722	25,572,481	$1.57
2005:			
Basic	$36,949,497	24,058,732	$1.54
Effect of stock options	—	774,848	(.05)
Diluted	$36,949,497	24,833,580	$1.49
2004:			
Basic	$31,614,269	23,394,551	$1.35
Effect of stock options	—	845,755	(.04)
Diluted	$31,614,269	24,240,306	$1.31

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:

	2006	2005	2004
Options excluded from diluted earnings per share	1,049,667	—	13,333

18 — Condensed Financial Information of Parent Company

Condensed Balance Sheets
(in thousands)

December 31,	2006	2005
Assets		
Fixed-maturity investments	$ 6,957	$ 4,192
Investment in subsidiaries/affiliates (equity method)	329,337	294,333
Short-term investments	15,029	9,431
Cash	1,114	938
Property and equipment	1,207	1,168
Other	1,215	1,110
Total assets	$354,859	$311,172
Liabilities and Stockholders' Equity		
Liabilities		
Cash dividends declared to stockholders	$ 2,443	$ 1,781
Subordinated debentures	30,929	30,929
Other	685	566
Total liabilities	34,057	33,276
Stockholders' equity	320,802	277,896
Total liabilities and stockholders' equity	$354,859	$311,172

Condensed Statements of Income and Comprehensive Income
(in thousands)

Year Ended December 31,	2006	2005	2004
Statements of Income			
Revenues			
Dividends from subsidiaries	$10,000	$ 2,000	$ 950
Other	1,642	1,276	1,242
Total revenues	11,642	3,276	2,192
Expenses			
Operating expenses	2,118	1,675	1,700
Interest	2,801	2,267	1,614
Total expenses	4,919	3,942	3,314
Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries	6,723	(666)	(1,122)
Income tax benefit	(1,136)	(862)	(727)
Income (loss) before equity in undistributed net income of subsidiaries	7,859	196	(395)
Equity in undistributed net income of subsidiaries	32,356	36,753	32,009
Net income	$40,215	$36,949	$31,614

(in thousands)

Year Ended December 31,	2006	2005	2004
Statements of Comprehensive Income			
Net income	$40,215	$36,949	$31,614
Other comprehensive income (loss), net of tax			
Unrealized loss — parent	(52)	(25)	(2)
Unrealized gain (loss) — subsidiaries	2,581	(2,192)	(539)
Other comprehensive income (loss), net of tax	2,529	(2,217)	(541)
Comprehensive income	$42,744	$34,732	$31,073

Condensed Statements of Cash Flows
(in thousands)

Year Ended December 31,	2006	2005	2004
Cash flows from operating activities:			
Net income	$ 40,215	$ 36,949	$ 31,614
Adjustments:			
Equity in undistributed net income of subsidiaries	(32,356)	(36,753)	(32,009)
Other	546	4,446	731
Net adjustments	(31,810)	(32,307)	(31,278)
Net cash provided	8,405	4,642	336
Cash flows from investing activities:			
Net purchase of fixed maturities	(2,917)	—	(2,084)

Net sale (purchase) of short-term investments	(5,598)	(3,846)	41,974
Net purchase of property and equipment	(546)	(392)	(246)
Investment in subsidiaries	(200)	—	(45,216)
Other	208	215	334
Net cash used	(9,053)	(4,023)	(5,238)
Cash flows from financing activities:			
Cash dividends paid	(7,782)	(6,813)	(5,985)
Issuance of common stock	6,307	5,551	6,948
Issuance of subordinated debentures	—	—	5,155
Tax benefit on exercise of stock options	2,299	—	—
Net cash provided (used)	824	(1,262)	6,118
Net change in cash	176	(643)	1,216
Cash at beginning of year	938	1,581	365
Cash at end of year	$ 1,114	$ 938	$ 1,581

19 — Segment Information

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, our insurance subsidiaries 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 our insurance subsidiaries' 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:

	2006	2005	2004
		(in thousands)	
Revenues			
Premiums earned:			
Commercial lines	$115,527	$112,711	$ 99,657
Personal lines	185,951	181,787	169,322
Total SAP premiums earned	301,478	294,498	268,979
GAAP adjustments	—	—	(3,140)
Total GAAP premiums earned	301,478	294,498	265,839
Net investment income	21,320	18,472	15,907
Realized investment gains	1,830	1,803	1,466
Other	5,339	5,074	4,577
Total revenues	$329,967	$319,847	$287,789

	2006	2005	2004
		(in thousands)	
Income before income taxes and extraordinary item:			
Underwriting income:			
Commercial lines	$22,495	$13,941	$ 6,209
Personal lines	9,288	14,232	10,100
SAP underwriting income	31,783	28,173	16,309
GAAP adjustments	1,270	2,765	2,109
GAAP underwriting income	33,053	30,938	18,418
Net investment income	21,320	18,472	15,907
Realized investment gains	1,830	1,803	1,466
Other	419	1,132	1,263
Income before income tax expense and extraordinary item	$56,622	$52,345	$37,054

20 — Guaranty Fund and Other Insurance-Related Assessments

Our insurance subsidiaries 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 insurance subsidiaries' liabilities for guaranty fund and other insurance-related assessments were $3,033,692 and $3,064,791 at December 31, 2006 and 2005, respectively. These liabilities included $358,393 and $361,192 related to surcharges collected by our insurance subsidiaries on behalf of regulatory authorities for 2006 and 2005, respectively.

21 — Interim Financial Data (unaudited)

	2006			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$74,513,849	$75,061,105	$75,705,387	$76,197,821
Total revenues	81,282,895	81,860,487	82,619,657	84,203,995
Net losses and loss expenses	43,288,512	40,783,828	42,555,787	41,793,298
Net income	9,130,187	10,220,583	9,818,301	11,045,651
Net income per common share				
Basic	0.37	0.41	0.39	0.44
Diluted	0.36	0.40	0.38	0.43

	2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$71,762,523	$73,438,090	$74,584,045	$74,713,365
Total revenues	78,079,058	79,492,080	80,566,455	81,709,601
Net losses and loss expenses	41,537,896	39,807,658	41,071,801	45,124,542
Net income	8,417,088	8,903,275	9,777,157	9,851,977
Net income per common share:				
Basic	0.35	0.37	0.41	0.41
Diluted	0.34	0.36	0.39	0.39

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2006 and 2005, 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, 2006. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006 in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for employee share-based payments in 2006.

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

KPMG LLP

Philadelphia, Pennsylvania
March 13, 2007

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. Under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, our management has conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2006, based on the framework and criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Framework").

Based on our evaluation under the COSO Framework, our management has concluded that our internal control over financial reporting was effective as of December 31, 2006.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

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

Our management's assessment of the effectiveness of our internal control over financial reporting has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their attestation report which is included herein.

Donald H. Nikolaus
President and Chief Executive Officer

Jeffrey D. Miller
Senior Vice President and Chief Financial Officer

March 13, 2007

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of Donegal Group Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Donegal Group Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Donegal Group Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that Donegal Group Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Donegal Group Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2006 and 2005, 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, 2006, and our report dated March 13, 2007 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

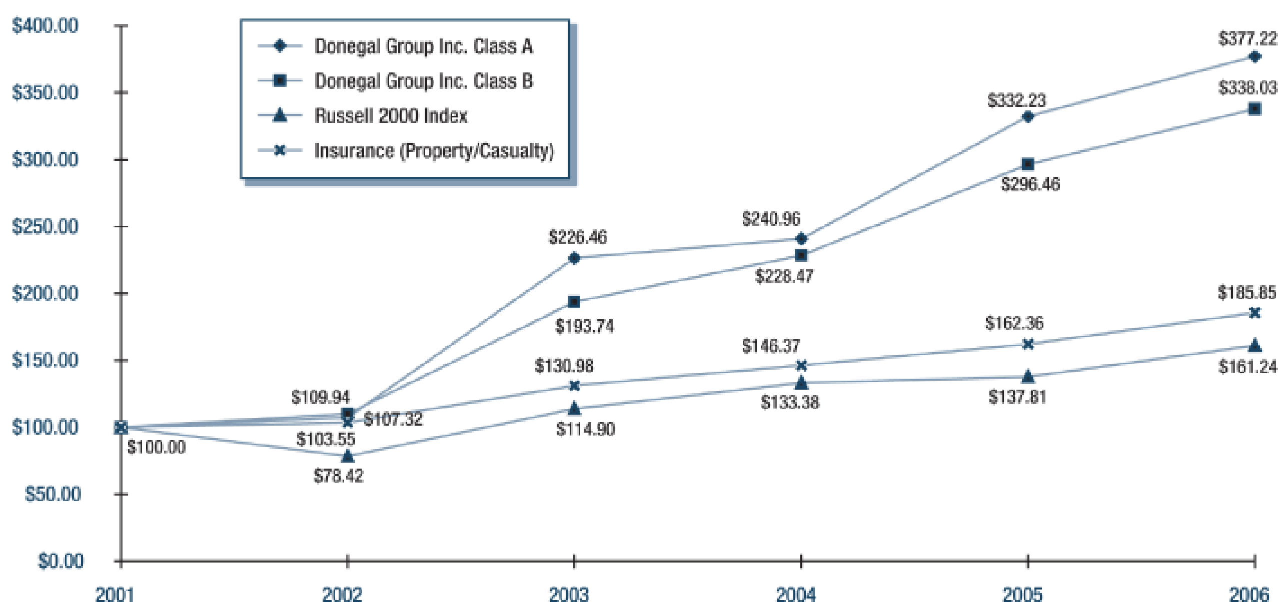
Philadelphia, Pennsylvania
March 13, 2007

Comparison of Total Return on Our Common Stock with Certain Averages

The following graph provides an indicator of cumulative total stockholder returns on our common stock compared to the Russell 2000 Index and a peer group of property and casualty insurance companies selected by Value Line, Inc. The members of the peer group are as follows: 21st Century Holding Company, 21st Century Insurance Group, ACA Capital Holdings, Inc., Acceptance Insurance Companies Inc., ACE Limited, Affirmative Insurance Holdings, Inc., Allied World Assurance Co. Holdings, Ltd, Allstate Corporation, AmCOMP Inc., American Financial Group, Inc., American Safety Insurance Holdings Ltd., AMERISAFE, Inc., AmTrust Financial Services, Inc., Anthony Clark International Insurance Brokers Ltd., Arch Capital Group Ltd., Argonaut Group Incorporated, Aspen Insurance Holdings Ltd., AssuranceAmerica Corporation, Assurant, Inc., Baldwin & Lyons Incorporated (Class A), Baldwin & Lyons Incorporated (Class B), Bristol West Holdings, Inc., Brooke Corporation, The Chubb Corporation, Cincinnati Financial Corporation, CNA Surety Corporation, CRM Holdings, Ltd., Darwin Professional Underwriters, Direct General Corporation, Donegal Group Inc. (Class B), eHealth, Inc., EMC Insurance Group Inc., Erie Indemnity Company (Class A), Everest Re Group Limited, Fairfax Financial Holdings Limited, Fidelity National Financial, Inc., First Mercury Financial Corporation, Fremont Michigan InsuraCorp Inc., GAINSCO, Inc., Harleysville Group Inc., HCC Insurance Holdings, Inc., Industrial Alliance Insurance and Financial Services Inc., Infinity Property & Casualty Corp., IPC Holdings, Ltd., James River Group, Inc., Kingsway Financial Services Inc., The KingThomason Group, Inc., Markel Corporation, Meadowbrook Insurance Group Inc., Mercer Insurance Group, Inc., Merchants Group Inc., Mercury General Corporation, Midland Company, MIIX Group Inc., Montpelier Re Holdings Ltd., National Atlantic Holdings Corporation, National Interstate Corporation, Odyssey Re Holdings Corp., Ohio Casualty Corporation, Old Republic International Corporation, OneBeacon Insurance Group, Ltd. (Class A), PartnerRe Ltd., Philadelphia Consolidated Holding Corp., Pico Holdings, Inc., PMA Capital Corporation (Class A), PMI Group Inc., ProCentury Corporation, Progressive Corporation, PXRE Group Ltd., Quanta Capital Holdings Ltd., RenaissanceRe Holdings Ltd., Republic Companies Group, Inc., RLI Corp., RTW, Inc., SAFECO Corporation, Safety Insurance Group, Inc., SCPIE Holdings Inc., SeaBright Insurance Holdings, Inc., Selective Insurance Group, Inc., St. Paul Travelers Companies, Inc., State Auto Corporation, Sun Life Financial Inc., The Hanover Insurance Group, Inc., Tower Group, Inc., TransAtlantic Holdings Inc., U.S.I. Holdings Corporation, United America Indemnity, Ltd., United Fire & Casualty Company, Universal Insurance Holdings, Inc., W.R. Berkley Corporation, XL Capital Ltd. (Class A) and Zenith National Insurance Corporation.

Comparison of Five-Year Cumulative Total Return*

Donegal Group Inc. Class A, Donegal Group Inc. Class B, Russell 2000 Index and Value Line Insurance (Property/Casualty)



Assumes $100 invested at the close of trading on December 31, 2001 in Donegal Group Inc. Class A common stock, Donegal Group Inc. Class B common stock, Russell 2000 Index and Insurance (Property/Casualty).

	2001	2002	2003	2004	2005	2006
Donegal Group Inc. Class A	100.00	107.32	226.46	240.96	332.23	377.22
Donegal Group Inc. Class B	100.00	109.94	193.74	228.47	296.46	338.03
Russell 2000 Index	100.00	78.42	114.00	133.38	137.81	161.24
Insurance (PropertyCasualty)	100.00	103.55	130.98	146.37	162.36	185.85

*Cumulative total return assumes reinvestment of dividends.

Corporate Information

Annual Meeting

April 19, 2007 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 Jeffrey D. Miller, 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 Global Select 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 2006 and 2005:

Quarter	High	Low	Cash Dividend Declared Per Share
2005 - Class A*			
1st	$15.93	$11.63	$ —
2nd	15.24	12.52	.075
3rd	17.99	14.49	.075
4th	18.70	15.18	.15
2005 - Class B*			
1st	$14.12	$10.55	$ —
2nd	14.25	10.88	.0638
3rd	15.00	12.42	.0638
4th	18.00	13.05	.1275
2006 - Class A			
1st	$19.64	$16.58	$ —
2nd	21.57	17.50	.0825
3rd	21.28	16.81	.0825
4th	20.48	18.70	.165
2006 - Class B			
1st	$21.86	$15.83	$ —
2nd	19.14	15.91	.07
3rd	19.07	14.01	.07
4th	18.10	15.84	.14

*Restated for a 4-for-3 stock split

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

Computershare Trust Company, N.A.
P.O. Box 43078
Providence, Rhode Island 02940-3078
(800) 317-4445
Web Site: www.computershare.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
Computershare Trust Company, N.A.
P.O. Box 43078
Providence, Rhode Island 02940-3078

Stockholders

The following represent the number of common stockholders of record as of December 31, 2006:

Class A common stock	1,105
Class B common stock	433

EXHIBIT 21

SUBSIDIARIES OF REGISTRANT

Registrant owns 100% of the outstanding stock of the following companies, except as noted:

Name	State of Formation
Atlantic States Insurance Company	Pennsylvania
Southern Insurance Company of Virginia	Virginia
Le Mars Insurance Company	Iowa
The Peninsula Insurance Company	Maryland
Peninsula Indemnity Company*	Maryland
Donegal Financial Services Corporation**	Delaware
Province BankFSB***	U.S.

* Wholly owned by The Peninsula Insurance Company.

** Registrant owns 48.2%. Donegal Mutual Insurance Company owns 51.8%.

*** Wholly owned by Donegal Financial Services Corporation.

EXHIBIT 23

REPORT AND CONSENT OF
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Donegal Group Inc.:

The audits referred to in our report dated March 13, 2007 with respect to the consolidated financial statements of Donegal Group Inc. and subsidiaries included the related financial statement schedule as of December 31, 2006, and for each of the years in the three-year period ended December 31, 2006, that is included in the annual report on Form 10-K. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits. In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents 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 statements (Nos. 333-59828 and 333-63102) on Form S-3 of Donegal Group Inc. of our reports dated March 13, 2007, with respect to the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2006 and 2005, 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, 2006, and the related financial statement schedule, management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2006 and the effectiveness of internal control over financial reporting as of December 31, 2006, which reports are incorporated by reference or appear in the December 31, 2006 annual report on Form 10-K of Donegal Group Inc.

Our report on the consolidated financial statements refers to a change in accounting for employee share-based payments in 2006.

/s/ KPMG LLP

Philadelphia, Pennsylvania

March 13, 2007

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, 2006 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15a-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) 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

(d) 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 13, 2007

EXHIBIT 31.2

CERTIFICATION

I, Jeffrey D. Miller, Senior Vice President and Chief Financial Officer of Donegal Group Inc., certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2006 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15a-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) 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

(d) 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/ Jeffrey D. Miller

Jeffrey D. Miller, Senior Vice President
and Chief Financial Officer

Date: March 13, 2007

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, 2006 (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 13, 2007

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, Jeffrey D. Miller, 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, 2006 (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/ Jeffrey D. Miller
Jeffrey D. Miller, Vice President and
Chief Financial Officer

Date: March 13, 2007