SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

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

For the fiscal year ended December 31, 1998
OR

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

For the transition period from ________________ to ________________

Commission file number 0-15341

DONEGAL GROUP INC.
(Exact name of registrant as specified in its charter)

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

Registrant's telephone number, including area code: (717) 426-1931

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

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

Common Stock, $1.00 par value
(Title of class)

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

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

On March 15, 1999, the aggregate market value (based on the closing sales price on that date) of the voting stock held by non-affiliates of the Registrant was $43,493,338.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 8,248,731 shares of Common Stock outstanding on March 15, 1999.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the Registrant's annual report to stockholders for the fiscal year ended December 31, 1998 are incorporated by reference into Parts I, II and IV of this report.

2. Portions of the Registrant's proxy statement relating to the annual meeting of stockholders to be held April 15, 1999 are incorporated by reference into Part III of this report.

DONEGAL GROUP INC.

INDEX TO FORM 10-K REPORT

PART I

Item 1. Business.

(a) General Development of Business.

Donegal Group Inc. is an insurance holding company formed in August 1986, which is headquartered in Pennsylvania and engages, through its subsidiaries, in the property and casualty insurance business in 19 mid-Atlantic and southeastern states. As used herein, "DGI" or the "Company" refers to Donegal Group Inc. and its insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Delaware Atlantic Insurance Company ("Delaware Atlantic"), Pioneer Insurance Company ("Pioneer") and Southern Heritage Insurance Company ("Southern Heritage"). DGI is currently 60% owned by Donegal Mutual Insurance Company (the "Mutual Company"). DGI and its subsidiaries and the Mutual Company underwrite a broad line of personal and commercial coverages, consisting of private passenger and commercial automobile, homeowners, commercial multi-peril, workers' compensation and other lines of insurance.

The Company's strategy is to seek growth both internally and through acquisitions. Since the formation of the Company and Atlantic States in 1986, the Company has completed the following acquisitions:

Company Acquired	Year Acquired	Net Premiums Written Year Prior to Acquisition	Net Premiums Written Year Ended December 31, 1998
Southern Insurance Company of Virginia	1988	$1,128,843	12,836,852
Delaware Atlantic Insurance Company	1995	2,824,398	3,795,928
Pioneer Insurance Company	1997	4,499,273	3,188,476
Southern Heritage Insurance Company	1998	32,002,540	27,856,117

The Company evaluates other acquisition candidates on a continuing basis. However, there can be no assurance as to whether or when the Company will effect any additional acquisitions.

Atlantic States, which DGI organized in September 1986, participates in an underwriting pool whereby it cedes to the Mutual Company the premiums, losses and loss adjustment expenses from all of its insurance business and assumes from the Mutual Company a specified portion of the pooled business, which also includes substantially all of the Mutual Company's property and casualty insurance business. Effective as of October 1, 1986, DGI entered into a pooling agreement with the Mutual Company whereby Atlantic States assumed 35% of the pooled business written or in force on or after October 1, 1986. Pursuant to amendments to the pooling agreement subsequent to October 1, 1986, the Mutual Company, which is solely responsible for any losses in the pooled business with dates of loss on or before the close of business on September 30, 1986, has increased the percentage of retrocessions of the pooled business to Atlantic States. Since January 1, 1996, 65% of the pooled business has been retroceded to Atlantic States. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Item 7 hereof and Note 3 to the Consolidated Financial Statements incorporated by reference herein.

On December 29, 1988, DGI acquired all of the outstanding capital stock of Southern in exchange for a $3,000,000 equity contribution to Southern. Since January 1, 1991, Southern has ceded to the Mutual Company 50% of its direct premiums written and 50% has been retained by Southern. Because the Mutual Company places substantially all of the business assumed from Southern in the pool, in which DGI has a 65% allocation, DGI's results of operations include approximately 80% of the business written by Southern. See Note 3 to the Consolidated Financial Statements incorporated by reference herein.

As of December 31, 1995, the Company acquired all of the outstanding capital stock of Delaware Atlantic pursuant to a Stock Purchase Agreement dated as of December 21, 1995 between the Company and the Mutual Company. As part of this transaction, the Mutual Company entered into an aggregate excess of loss reinsurance agreement with Delaware Atlantic for a specified period. This reinsurance agreement did not result in any additional payment from the Mutual Company to Delaware Atlantic.

Effective July 1, 1996, the Mutual Company entered into retrocessional reinsurance agreements with each of Southern, Delaware Atlantic and Pioneer (individually, an "Affiliate"), whereby the Mutual Company agreed to reinsure each Affiliate in respect of 100% of the net liability that may accrue to such Affiliate from its insurance operations and retrocede 100% of the net liability back to each Affiliate, which the Affiliate assumes.

As of March 31, 1997, the Company acquired all of the outstanding capital stock of Pioneer pursuant to a stock purchase agreement dated as of April 7, 1997 between the Company and the Mutual Company. As part of this transaction, the Mutual Company entered into an aggregate excess of loss reinsurance agreement with Pioneer whereby the Mutual Company assumed the risk of any loss from an adverse development in Pioneer's loss and loss adjustment expense reserve at the end of 1996 compared to the end of 1998 by reason of the fact that Pioneer's loss and loss adjustment expense ratio for those periods exceeded the lesser of the loss and loss expense ratios of immediately preceding periods or 60%. This reinsurance agreement resulted in additional payments of $306,400 from the Mutual Company to Pioneer in 1998.

On November 17, 1998, DGI purchased all of the outstanding capital stock of Southern Heritage, a Georgia-domiciled property and casualty insurance company, from Southern Heritage Limited Partnership for a purchase price of $18,361,279 in cash. The purchase price is subject to adjustment based upon the final determination of certain account balances of

Southern Heritage as of October 31, 1998 and the resolution of certain breach of representation and warranty claims that DGI has asserted against Southern Heritage Limited Partnership.

Unless otherwise stated, all information in this report gives retroactive effect to: (i) the four-for-three split of the Company's Common Stock effected through a stock dividend of one share of Common Stock for each three shares outstanding, which was paid on July 15, 1997 to stockholders of record on June 25, 1997, and (ii) the four-for-three split of the Company's Common Stock effected through a stock dividend of one share of Common Stock for each three shares outstanding, which was paid on June 25, 1998 to stockholders of record on June 10, 1998.

(b) Financial Information about Industry Segments.

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

(c) Narrative Description of Business.

Relationship with the Mutual Company

DGI's operations are interrelated with the operations of the Mutual Company and, because of the percentage of the pooled business assumed by DGI, DGI's results of operations are dependent to a material extent upon the success of the Mutual Company. In addition, various reinsurance agreements exist between the Company and the Mutual Company. The Mutual Company is responsible for underwriting and marketing the pooled business and provides facilities, employees and services required to conduct the business of DGI on a cost allocated basis. The Mutual Company owned 60% of DGI as of March 15, 1999.

Through the pool, DGI writes personal and commercial property and casualty insurance lines, including automobile, homeowners, commercial multi-peril, workers' compensation and other lines of business. The insurance agencies under contract with the Mutual Company serve as representatives for the pool participants.

Under the terms of the intercompany pooling agreement, which took effect on October 1, 1986, Atlantic States cedes to the Mutual Company the premiums, losses and loss expenses on all of its insurance business. Substantially all of the Mutual Company's property and casualty insurance business, including the business reinsured from Southern, written or in force on or after October 1, 1986, is also included in the pooled business. Pursuant to amendments to the pooling agreement subsequent to October 1, 1986, the Mutual Company, which is solely responsible for any losses in the pooled business with dates of loss on or before the close of business on September 30, 1986, has increased the percentage of retrocessions of the pooled business to Atlantic States. Since January 1, 1996, 65% of the pooled business has been retroceded to Atlantic States. All premiums, losses, loss expenses, other underwriting expenses and policy dividends are prorated among the parties on the basis of their participation in the pool. The pooling agreement may be amended or terminated at the end of any calendar year by agreement of the parties. The Company does not intend to terminate its participation in the pooling agreement. The allocations of pool participation percentages between the Mutual Company and Atlantic States are based on the pool participants' relative amounts of capital and surplus and expectations of future relative amounts of capital and surplus. The pooling agreement does not legally discharge Atlantic States from its primary liability for the full amount of the policies ceded. However, it makes the Mutual Company liable to Atlantic States to the extent of the business ceded.

All of DGI's officers are officers of the Mutual Company, and five of DGI's seven directors are directors of the Mutual Company. A Coordinating Committee, which consists of two outside directors from each of DGI and the Mutual Company, none of whom holds seats on the Boards of Directors of both DGI and the Mutual Company, reviews and approves changes in the pooling agreement and is responsible for matters involving actual or potential conflicts of interest. The decisions of the Coordinating Committee are binding on the two companies. DGI's members must conclude that intercompany transactions are fair and reasonable in order for such transactions to be approved.

The underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for the companies in the pool than they would experience individually and to spread the risk of loss among all the participants. Each company participating 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 additional capacity exists because such policy exposures are spread among the pool participants, each of which have their own capital and surplus.

In addition to the underwriting pool, through the retrocessional reinsurance agreements with each of Southern, Delaware Atlantic and Pioneer, the Mutual Company reinsures each Affiliate in respect of 100% of the net liability that may accrue to such Affiliate from its insurance operations and the Mutual Company retrocedes 100% of the net liability back to each Affiliate, which the Affiliate assumes as part of the retrocession.

DGI's Business Strategy

DGI, in conjunction with the Mutual Company, has multiple strategies which the management of DGI believes have resulted in underwriting results that are favorable when compared to those of the property and casualty insurance industry in general over the past five years. The principal strategies comprise the following:

- A regional company concept designed to provide the advantages of local marketing, underwriting and claims servicing with the economies of scale from centralized accounting, administrative, investment, data processing and other services.

- An underwriting program and product mix designed to produce a Company-wide underwriting profit, i.e., a combined ratio of less than 100%, from careful risk selection and adequate pricing.

- A goal of a closely balanced ratio between commercial business and personal business.

- An agent selection process that focuses on appointing agencies with proven market strategies for the development of profitable business and an agent compensation plan providing for additional commissions based upon premium volume and profitability and the right to participate in the Company's Agency Stock Purchase Plan.

- A continuing effort to attract and retain qualified employees who receive incentive compensation based upon historical results.

- A goal of expanding operations in current and adjacent states.

Property and Casualty Insurance Products and Services

The following table indicates the percentage of DGI's net premiums written represented by commercial lines and by personal lines for the years ended December 31, 1998, 1997 and 1996:

	Year Ended December 31,		
	1998	1997	1996
Net Premiums Written:			
Commercial	38.2%	41.0%	44.3%
Personal	61.8%	59.0%	55.7%

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

Commercial

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

- 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 multi-peril -- policies that provide protection to businesses against many perils, usually combining liability and physical damage coverages.

Personal

- Private passenger automobile -- policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and provide 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.

The following table sets forth the combined ratios of DGI, prepared in accordance with generally accepted accounting principles and statutory accounting principles prescribed or permitted by state insurance authorities. The combined ratio is a traditional measure of underwriting profitability. When the combined ratio is under 100%, underwriting results are generally considered profitable. Conversely, when the combined ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. DGI's operating income depends on income from both underwriting operations and investments.

	Year Ended December 31,		
	1998	1997	1996
GAAP combined ratio	99.8%	97.6%	100.4%
Statutory operating ratios:			
Loss ratio	64.0	64.0	68.4
Expense ratio	35.4	34.0	31.1
Dividend ratio	1.4	1.2	1.5
Statutory combined ratio	100.8%	99.2%	101.0%
Industry statutory combined ratio(1)	105.6%	101.6%	107.0%

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(1) Source: A.M. Best Co.

DGI is required to participate in involuntary insurance programs for automobile insurance, as well as other property and casualty insurance lines, in states in which DGI operates. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements ("FAIR") plans, reinsurance facilities and windstorm plans. Legislation establishing these programs requires all companies that write lines covered by these programs to provide coverage (either directly or through reinsurance) for insureds who cannot obtain insurance in the voluntary market. The legislation creating these programs usually allocates a pro rata portion of risks attributable to such insureds to each company on the basis of direct premiums written or the number of automobiles insured. 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 in the voluntary market. During 1998, the Company received an assessment from the Pennsylvania Insurance Guaranty Association totaling $1.3 million relating to the insolvency of two medical malpractice insurers. The impact of these involuntary programs on DGI were not material during 1996 and 1997.

The following table sets forth the net premiums written and combined ratios by line of insurance for the business of DGI, prepared in accordance with statutory accounting practices prescribed or permitted by state insurance authorities, for the periods indicated.

	Year Ended December 31,		
	1998	1997	1996
	(dollars in thousands)		
Net Premiums Written:			
Commercial:			
Automobile	$ 11,120	$ 10,522	$ 10,149
Workers' compensation	15,446	15,590	17,998
Commercial multi-peril	17,046	16,357	17,153
Other	1,473	1,612	3,127
Total commercial	45,085	44,081	48,427
Personal:			
Automobile	46,609	38,989	37,739
Homeowners	21,737	19,939	18,979
Other	4,724	4,597	4,070
Total personal	73,070	63,525	60,788
Total business	$118,155	$107,606	$109,215
Statutory Combined Ratios:			
Commercial:			
Automobile	118.2%	89.9%	97.6%
Workers compensation	80.4	89.5	67.2
Commercial multi-peril	85.6	103.0	106.4
Other	71.1	57.7	42.8
Total commercial	91.3	93.5	86.5
Personal:			
Automobile	104.2	98.7	100.7
Homeowners	115.7	116.4	139.1
Other	91.2	87.6	109.6
Total personal	106.7	103.4	112.7
Total business	100.8%	99.2%	101.0%

Property and Casualty Underwriting

The underwriting department is responsible for the establishment of underwriting and risk selection guidelines and criteria for the various insurance products written by DGI. The underwriting department, in conjunction with the marketing representatives, works closely with DGI's independent agents to insure a comprehensive knowledge on the part of the agents of DGI's underwriting requirements and risk selection process.

DGI's underwriting and pricing strategy is designed to produce an underwriting profit resulting in a Company-wide combined ratio below 100%. DGI and the Mutual Company have a conservative underwriting philosophy, which, in the opinion of management, is one of the prime reasons for DGI's favorable loss ratios relative to the property and casualty insurance industry over the last five years.

The underwriting department has over time initiated risk inspection procedures and underwriting analyses on a per risk and class of business basis. It has also automated underwriting processing utilizing technology such as bar coding. Management has established monitoring and auditing processes to verify compliance with underwriting requirements and procedures.

The underwriting department and the research and development department are responsible for the development of new insurance products and enhancements of existing products. Underwriting profitability is enhanced by the creation of niche products focused on classes of business which traditionally have provided underwriting profits.

Marketing

DGI's insurance products, together with the products of the Mutual Company and their respective subsidiaries, are marketed through approximately 3,300 independent insurance agents associated with approximately 1,200 insurance agencies. Business is written by either DGI or the Mutual Company depending upon geographic location, agency license and product. Management has developed an agency appointment procedure that focuses on appointing agencies with proven marketing strategies for the development of profitable business. DGI regularly evaluates its agency force and continues to strive to obtain and retain a significant position within each agency relative to the amount of business similar to that of DGI placed by the agency with other insurers. DGI and the Mutual Company have developed a successful contingent commission plan for agents under which additional commissions are payable based upon the volume of premiums produced and the profitability of the business of the agency written by DGI and the Mutual Company. Management believes the contingent commission program and the Company's Agency Stock Purchase Plan have enhanced the ability of DGI and the Mutual Company to write profitable business.

DGI has granted certain agents the authority to bind insurance within underwriting and pricing limits specified by DGI without the prior approval of DGI. However, DGI generally reviews all coverages placed by its agents and, subject to applicable insurance regulations, may cancel the coverage if it is inconsistent with DGI's guidelines.

DGI believes that its regional structure enables it to compete effectively with large national companies. This regional structure permits DGI to take advantage of its knowledge of local operating territories and the opportunity to form strong, long-term relationships with the agents that represent DGI and the Mutual Company.

DGI and the Mutual Company have developed comprehensive growth strategies for each of the commercial and personal lines of insurance business. DGI has focused on the small- to medium-sized commercial insurance markets, which have traditionally been a more stable and profitable segment of the property and casualty insurance business than the large commercial insurance markets, which have become increasingly competitive in the past several years. Commercial lines marketing is characterized by account selling, in which multiple lines of insurance are offered to a single policyholder.

DGI believes that competitive and comprehensive products targeted to selected classes of personal lines business, along with excellent service to agents and policyholders, provides a foundation for growth and profitability. As is customary in the industry, insureds are encouraged to place both their homeowners and personal automobile insurance with DGI or the Mutual Company and are offered a discount for doing so.

Claims

The claims department develops and implements policies and procedures for the establishment of claim reserves and the timely resolution and payment of claims. The management and staff of the claims department resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters.

Insurance claims are normally investigated and adjusted by internal claims adjusters and supervisory personnel. Independent adjusters are employed as needed to handle claims in territories in which the volume of claims is not sufficient to justify hiring internal claims adjusters. The litigation and personal injury sections manage all claims litigation, and all claims above $25,000 require home office review and settlement authorization.

Field office staffs are supported by home office technical, litigation, material damage, subrogation and medical audit personnel who provide specialized claims support. An investigative unit attempts to prevent fraud and abuse and to control losses.

Liabilities for Losses and Loss Expenses

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

DGI maintains liabilities for the eventual payment of losses and loss expenses with respect to both reported and unreported claims. Liabilities for loss expenses are intended to cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. The amount of liability for reported losses is primarily based upon a case-by-case evaluation of the type of risk involved and knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amount of liability for unreported claims and loss expenses is determined on the basis of historical information by line of insurance. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results. Liabilities are closely monitored and are recomputed periodically by the Company and the Mutual Company using new information on reported claims and a variety of statistical techniques. Liabilities for losses are not discounted.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that the ultimate liability will not exceed DGI's loss and loss expenses and have an adverse effect on DGI's results of operations and financial condition. As is the case for virtually all property and casualty insurance companies, DGI has found it necessary in the past to revise estimated future liabilities for losses and loss expenses in non-material amounts, and further adjustments could be required in the future. However, on the basis of DGI's internal procedures, which analyze, among other things, DGI's 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, management of DGI believes that adequate provision has been made for DGI's liability for losses and loss expenses.

Differences between liabilities reported in DGI's financial statements prepared on the basis of generally accepted accounting principles and financial statements prepared on a statutory accounting basis result from reducing statutory liabilities for anticipated salvage and subrogation recoveries. These differences amounted to $7,963,559, $6,155,467 and $5,170,486 at December 31, 1998, 1997 and 1996, respectively.

The following tables set forth a reconciliation of the beginning and ending net liability for unpaid losses and loss expenses for the periods indicated on a GAAP basis for the Company.

	Year Ended December 31,		
	1998	1997	1996
	(in thousands)		
Net liability for unpaid losses and loss expenses at beginning of year	$77,474	$75,428	$71,155
Net liabilities of acquired company	14,967	--	--
Net beginning balance as adjusted	$92,441	$75,428	$71,155
Provision for net losses and loss expenses for claims incurred in the current year	75,463	69,040	73,212
Decrease in provision for estimated net losses and loss expenses for claims incurred in prior years	(2,296)	(1,384)	(2,791)
Total incurred	73,167	67,656	70,421
Net losses and loss payments for claims incurred during:			
The current year	44,389	39,133	42,669
Prior years	27,356	26,477	23,479
Total paid	71,745	65,610	66,148
Net liability for unpaid losses and loss expenses at end of year	$93,863	$77,474	$75,428

The following table sets forth the development of the liability for net unpaid losses and loss expenses for DGI on a GAAP basis from 1988 to 1998, with supplemental loss data for 1998 and 1997.

"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 "Liability reestimated as of" portion of the table shows the reestimated amount of the previously recorded liability based on experience for each succeeding year. The estimate is increased or decreased as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 1990 liability has developed an excess after eight years, in that reestimated net losses and loss expenses are expected to be less than the estimated liability initially established in 1990 of $31,898 by $2,723.

The "Cumulative deficiency (excess)" shows the cumulative deficiency or excess at December 31, 1998 of the liability estimate shown on the top line of the corresponding column. An excess in liability means that the liability established in prior years exceeded actual net losses and loss expenses or were reevaluated at less than the original amount. A deficiency in liability means that the liability established in prior years was less than actual net losses and loss expenses or were reevaluated at more than the original amount.

The "Cumulative amount of liability paid through" portion of the table shows the cumulative net losses and loss expense payments made in succeeding years for net losses incurred prior to the balance sheet date. For example, the 1990 column indicates that as of December 31, 1998 payments equal to $28,841 of the currently reestimated ultimate liability for net losses and loss expenses of $29,175 had been made.

	Year Ended December 31										
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
	(in thousands)										
Net liability at end of year for unpaid losses and loss expenses	$20,734	$27,767	$31,898	$36,194	$44,339	$ 52,790	$ 63,317	$71,155	$75,428	$77,474	$93,863
Net liability reestimated as of:											
One year later	21,598	29,175	32,923	37,514	45,408	50,583	60,227	68,348	74,044	75,178	
Two years later	20,475	28,861	33,550	37,765	42,752	48,132	56,656	66,520	70,545		
Three years later	19,823	28,545	32,803	35,446	40,693	44,956	54,571	63,187			
Four years later	19,296	27,717	31,004	33,931	38,375	42,157	51,825				
Five years later	18,796	26,759	30,041	32,907	37,096	41,050					
Six years later	18,457	26,180	29,595	32,234	36,682						
Seven years later	18,189	25,971	29,417	31,976							
Eight years later	18,117	25,828	29,175								
Nine years later	18,050	25,904									
Ten years later	18,015										
Cumulative deficiency (excess)	$(2,719)	$(1,863)	$(2,723)	$(4,218)	$(7,657)	$(11,740)	$(11,492)	$(7,968)	$(4,883)	$(2,296)	
Cumulative amount of liability paid through:											
One year later	$ 8,855	$11,401	$13,003	$13,519	$16,579	$ 16,126	$ 19,401	$23,479	$26,477	$27,356	
Two years later	12,280	17,421	19,795	20,942	24,546	25,393	30,354	37,078	40,384		
Three years later	14,912	20,986	24,178	25,308	29,385	32,079	38,684	45,796			
Four years later	16,292	23,268	26,413	27,826	32,925	36,726	43,655				
Five years later	17,201	24,331	27,439	29,605	34,757	39,122					
Six years later	17,706	24,909	28,157	30,719	35,739						
Seven years later	17,782	25,280	28,627	31,173							
Eight years later	17,884	25,599	28,841								
Nine years later	17,986	25,695									
Ten years later	17,980										

	Year Ended December 31						
	1992	1993	1994	1995	1996	1997	1998
	(in thousands)						
Gross liability at end of year	$57,777	$70,093	$88,484	$98,894	$114,622	$118,112	$141,409
Reinsurance recoverable	13,438	17,303	25,167	27,739	39,194	40,638	47,546
Net liability at end of year	44,339	52,790	63,317	71,155	75,428	77,474	93,863
Gross reestimated liability -- latest	58,733	56,969	76,260	89,706	109,735	118,309	
Reestimated recoverable -- latest	22,051	15,919	24,435	26,519	39,190	43,131	
Net reestimated liability -- latest	36,682	41,050	51,825	63,187	70,545	75,178	
Gross cumulative deficiency (excess)	956	(13,124)	(12,224)	(9,188)	(4,887)	197	

Reinsurance

DGI and the Mutual Company use several different reinsurers, all of which have a Best rating of A- or better or, with respect to foreign reinsurers, have a financial condition which, in the opinion of management, is equivalent to a company with at least an A- rating.

The external reinsurance purchased by DGI and the Mutual Company includes "excess treaty reinsurance," under which losses are automatically reinsured over a set retention ($250,000 for 1998), and "catastrophic reinsurance," under which the reinsured recovers 95% of an accumulation of many losses resulting from a single event, including natural disasters (for 1998, $3,000,000 retention). DGI's principal reinsurance agreement in 1998, other than that with the Mutual Company, was an excess of loss treaty in which the reinsurers were Continental Casualty Company, Employers Reinsurance Corporation and Dorinco Reinsurance Company. Reinsurance is also purchased on an individual policy basis to reinsure losses that may occur from large risks, specific risk types or specific locations. 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. For property insurance, excess of loss treaties provide for coverage up to $1,000,000. For liability insurance, excess of loss treaties provide for coverage up to $30,000,000. Property catastrophe contracts provide coverage up to $70,000,000 resulting from one event. On both property and casualty insurance, DGI and the Mutual Company purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by their respective treaty reinsurance. Atlantic States cedes to the Mutual Company all of its insurance business and assumes from the Mutual Company 65% of the Mutual Company's total pooled insurance business, including that assumed from Atlantic States and substantially all of the business assumed and retained by the Mutual Company from Southern and Delaware Atlantic. Atlantic States, Southern, Delaware Atlantic and Pioneer each have a catastrophe reinsurance agreement with the Mutual Company which limits the maximum liability under any one catastrophic occurrence to $400,000, $300,000, $300,000 and $200,000, respectively, and $700,000 for a catastrophe involving more than one of the companies. The Mutual Company and Delaware Atlantic have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $200,000 of losses in excess of $50,000 and a workers' compensation quota share agreement whereby Delaware Atlantic cedes 70% of that business. The Mutual Company and Pioneer have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $200,000 of losses in excess of $50,000. The Mutual Company and Pioneer also have an aggregate excess of loss reinsurance agreement, entered into as part of the sale of Pioneer from the Mutual Company to the Company, in which the Mutual Company agrees to assume the adverse loss development of claims with dates of loss prior to December 31, 1996, as developed through December 31, 1998, and to assume losses in excess of a 60% loss ratio through December 31, 1998. The Mutual Company and Southern have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $25,000 of losses in excess of $100,000 and a quota share agreement whereby Southern cedes 50% of its direct business less certain reinsurance to the Mutual Company. Southern, Delaware Atlantic and Pioneer each have retrocessional reinsurance agreements effective July 1, 1996 with the Mutual Company, under which they cede, and then assume back, 100% of their business net of other reinsurance.

Competition

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

Investments

DGI's return on invested assets is an important element of its financial results. Currently, the investment objective is to maintain a widely diversified fixed maturities portfolio structured to maximize after-tax investment income while minimizing credit risk through investments in high quality instruments. At December 31, 1998, all debt securities were rated investment grade with the exception of one unrated obligation of $10,000, and the investment portfolio did not contain any mortgage loans or any non-performing assets.

The following table shows the composition of the debt securities investment portfolio (at carrying value), excluding short-term investments, by rating as of December 31, 1998:

	December 31, 1998	
Rating(1)	Amount	Percent
	(dollars in thousands)	
U.S. Treasury and U.S. agency agency securities(2)	$104,188	47.8%
Aaa or AAA	61,786	28.4
Aa or AA	36,486	16.8
A	15,138	7.0
BBB	102	--
Not rated(3)	10	--
Total	$217,710	100%

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

(2) Includes mortgage-backed securities of $22,563.

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

DGI invests in both taxable and tax-exempt securities as part of its strategy to maximize after-tax income. Such strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 34.1%, 34.3% and 36.4% of the total investment portfolio at December 31, 1998, 1997 and 1996, respectively.

The following table shows the classification of the investments (at carrying value) of DGI and its subsidiaries at December 31, 1998, 1997 and 1996.

	December 31,					
	1998		1997		1996	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)					
Fixed maturities(1):						
Held to maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 32,891	12.9%	$ 41,450	20.2%	$38,64	20.1%
Obligations of states and political subdivisions	66,941	26.2	57,621	28.1	57,095	29.6
Corporate securities.............	9,131	3.6	7,250	3.5	5,917	3.1
Mortgage-backed securities.............	18,221	7.1	10,925	5.4	12,680	6.6
Total held to maturity	127,184	49.8	117,246	57.2	114,339	59.4
Available for sale:						
U.S. treasury securities and obligations of U.S. government corporations and agencies	55,439	21.8	40,197	19.6	35,507	18.4
Obligations of states and political subdivisions	19,957	7.8	12,762	6.2	12,987	6.8
Corporate securities	10,787	4.2	3,252	1.6	3,436	1.8
Mortgage-backed securities	4,342	1.7	1,520	0.8	1,606	0.8
Total available for sale	90,525	35.5	57,731	28.2	53,536	27.8
Total fixed maturities	217,709	85.3	174,977	85.4	167,875	87.2
Equity securities(2)	6,764	2.7	7,275	3.5	3,143	1.6
Short-term investments(3)	30,522	12.0	22,713	11.1	21,471	11.2
Total investments	$254,995	100.0%	$204,965	100.0%	$192,489	100.0%

(1) The Company accounts for its 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 4 to the Consolidated Financial Statements incorporated by reference herein. Fixed maturities held to maturity are valued at amortized cost; those fixed maturities available for sale are valued at fair value. Total fair value of fixed maturities held to maturity was $131,633,299 at December 31, 1998, $120,882,886 at December 31, 1997 and $116,264,317 at December 31, 1996. The amortized cost of fixed maturities available for sale was $89,089,995 at December 31, 1998, $56,922,342 at December 31, 1997 and $53,264,748 at December 31, 1996.

(2) Equity securities are valued at fair value. Total cost of equity securities was $6,206,735 at December 31, 1998, $6,551,020 at December 31, 1997 and $2,774,946 at December 31, 1996.

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

The following table sets forth the maturities (at carrying value) in the fixed maturity and short-term investment portfolio at December 31, 1998, December 31, 1997 and December 31, 1996.

	December 31,					
	1998		1997		1996	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)					
Due in:(1)						
One year or less	$ 47,760	19.2%	$ 36,013	18.2%	$ 34,836	18.4%
Over one year through three years	31,964	12.9	30,910	15.6	26,392	13.9
Over three years through five years	23,139	9.3	20,303	10.3	21,163	11.2
Over five years through ten years	78,061	31.4	65,122	32.9	45,370	24.0
Over ten years through ffiteen years	37,940	15.3	32,384	16.4	46,248	24.4
Over fifteen years	6,805	2.8	513	0.3	1,051	0.6
Mortgage-backed securities	22,563	9.1	12,445	6.3	14,286	7.5
	$248,232	100.0%	$197,690	100.0%	$189,346	100.0%

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(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, the Company held investments in mortgage-backed securities having a carrying value of $22,563 at December 31, 1998. Included in these investments are collateralized mortgage obligations ("CMOs") with a carrying value of $22,287 at December 31, 1998. The Company has attempted to reduce the prepayment risks associated with mortgage-backed securities by investing approximately 99%, as of December 31, 1998, of the Company's holdings of CMOs in planned amortization and very accurately defined tranches. Such investments are designed to alleviate the risk of prepayment by providing predictable principal prepayment schedules within a designated range of prepayments. If principal is repaid earlier than originally anticipated, investment yields may decrease due to reinvestment of the proceeds at lower current interest rates and capital gains or losses may be realized since the book value of securities purchased at premiums or discounts may be different from the prepayment amount.

Investment results of DGI and its subsidiaries for the years ended December 31, 1998, 1997 and 1996 are shown in the following table:

	Year Ended December 31,		
	1998	1997	1996
	(dollars in thousands)		
Invested assets(1).............	$208,304	$202,283	$183,401
Investment income(2)...........	11,998	11,507	10,799
Average yield..................	5.6%	5.7%	5.9%

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

(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

In 1998, the A.M. Best rating of the Mutual Company, Atlantic States, Southern, Delaware Atlantic and Pioneer was "A", based upon their respective current financial conditions and historical statutory results of operations. Southern Heritage, which DGI acquired in November 1998, currently has a Best rating of B++. Management believes that this Best rating is an important factor in marketing DGI's products to its agents and customers. Best's ratings are industry ratings based on a comparative analysis of the financial condition and operating performance of insurance companies as determined by their publicly available reports. 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). Best's ratings are based upon factors relevant to policyholders and are not directed toward the protection of investors. According to Best, an "excellent" rating is assigned to those companies which, in Best's opinion, have achieved excellent overall performance when compared to the norms of the property and casualty insurance industry and have generally demonstrated a strong ability to meet policyholder and other contractual obligations.

Regulation

Insurance companies are subject to supervision and regulation in the states in which they transact business. Such supervision and regulation relates 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 which 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 which 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, in December 1993 the National Association of Insurance Commissioners (the "NAIC") adopted a risk-based capital system for assessing the adequacy of statutory capital and surplus which augments the states' current fixed dollar minimum capital requirements for insurance companies. At December 31, 1998, DGI's insurance subsidiaries each exceeded the required levels of capital. There can be no assurance that the capital requirements applicable to DGI's insurance subsidiaries will not increase in the future.

The states in which Atlantic States (Pennsylvania, Maryland and Delaware), the Mutual Company (Pennsylvania, Ohio, Maryland, New York, Virginia, Delaware and North Carolina), Southern (Virginia and Pennsylvania), Delaware Atlantic (Delaware, Maryland and Pennsylvania), Pioneer (Ohio and Pennsylvania) and Southern Heritage (Alabama, Arkansas, Florida, Georgia, Illinois, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee and Virginia) do business have guaranty fund laws under which insurers doing business in such states 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. The Mutual Company, Atlantic States, Southern, Delaware Atlantic, Pioneer and Southern Heritage have made accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations. During 1998, the Company received an assessment from the Pennsylvania Insurance Guaranty Association totaling $1.3 million relating to the insolvency of two medical malpractice insurers. For 1996 and 1997, assessments paid by the Company were not material.

The property and casualty insurance industry has recently received a considerable amount of publicity because of rising insurance costs and the unavailability of insurance. New regulations and legislation are being proposed to limit damage awards, to control plaintiffs' counsel fees, to bring the industry under regulation by the federal government and to control premiums, policy terminations and other policy terms. It is not possible to predict whether, in what form or in what jurisdictions any of these proposals might be adopted or the effect thereof, if any, on the Company.

Most states have enacted legislation that regulates insurance holding company systems. Each insurance company in the holding company system is required to register with the insurance supervisory agency of its state of domicile and furnish information concerning the operations of companies within the holding company system that may materially affect the operations, management or financial condition of the insurers within the system. Pursuant to these laws, the respective insurance departments may examine the Mutual Company, the Company and their respective insurance subsidiaries 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.

All transactions within the holding company system affecting the Mutual Company and the Company's insurance subsidiaries must be fair and equitable. Approval of the applicable insurance commissioner is required prior to consummation of transactions affecting the control of an insurer. In some states, including Pennsylvania, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company is presumed to be a change in control. Pursuant to an order issued in October 1998, the Pennsylvania Insurance Department has approved the Mutual Company's ownership of up to 65% of the outstanding Common Stock of DGI. These 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.

The Company's 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 the Company 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 a certain date, or the net income or net investment income not including realized capital gains of the subsidiary for the preceding year. As of December 31, 1998, amounts available for payment of dividends in 1999 without the prior approval of the various insurance commissioners were $6,480,524 from Atlantic States, $638,832 from Southern, $1,085,807 from Delaware Atlantic, $530,035 from Pioneer and $1,580,564 from Southern Heritage. See Note 12 to the Consolidated Financial Statements incorporated by reference herein.

The Mutual Company

The Mutual Company, which was organized in 1889, has a Best rating of A (Excellent). At December 31, 1998, the Mutual Company had admitted assets of $182,704,688 and policyholders' surplus of $98,549,558. At December 31, 1998, the Mutual Company had no debt and, of its total liabilities of $84,155,130, reserves for net losses and loss expenses accounted for $46,442,067 and unearned premiums accounted for $23 million. Of the Mutual Company's investment portfolio of $137,594,316 at December 31, 1998, investment-grade bonds accounted for $40,356,021, cash and short-term investments accounted for $2 million and mortgages accounted for $7,940,878. At December 31, 1998, the Mutual Company owned 4,918,364 shares of the Company's Common Stock, which were carried on the Mutual Company's books at $76,849,434. The foregoing financial information is presented on the statutory basis of accounting.

Employees

As of December 31, 1998, the Mutual Company had 372 employees. The Mutual Company's employees provide a variety of services to DGI, Atlantic States, Delaware Atlantic, Southern, Pioneer and Southern Heritage as well as to the Mutual Company and its subsidiaries. As of December 31, 1998, Southern Heritage had 69 employees.

Item 2. Properties.

DGI shares headquarters with the Mutual Company in a building owned by the Mutual Company. The Mutual Company charges DGI for an appropriate portion of the building expenses under an intercompany allocation agreement which is consistent with the terms of the pooling agreement. The headquarters of the Mutual Company has approximately 163,500 square feet of office space. Southern has a facility of approximately 10,000 square feet in Glen Allen, Virginia, which it owns. Delaware Atlantic has a facility of approximately 3,000 square feet in Wilmington, Delaware, which it leases. Pioneer has a facility of approximately 10,000 square feet in Greenville, Ohio, which it owns. Southern Heritage has a facility of approximately 14,000 square feet in Duluth, Georgia, which it leases.

Item 3. Legal Proceedings.

DGI is a party to numerous lawsuits arising in the ordinary course of its insurance business. DGI believes that the resolution of these lawsuits will not have a material adverse effect on its financial condition or results of operations.

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

No matter was submitted to a vote of holders of the Company's Common Stock during the fourth quarter of 1998.

Executive Officers of the Company

Name	Age	Position
Donald H. Nikolaus	56	President and Chief Executive Officer since 1981
Ralph G. Spontak	46	Senior Vice President since 1991; Chief Financial Officer and Vice President since 1983; Secretary since 1988
Cyril J. Greenya	54	Senior Vice President - Commercial Underwriting since 1997; Vice President - Commercial Underwriting for five years prior thereto; Manager - Commercial Underwriting for nine years prior thereto
Frank J. Wood	65	Senior Vice President - Marketing since 1997; Vice-President - Marketing for nine years prior thereto; Manager - Marketing for one year prior thereto

James B. Price	63	Senior Vice President - Claims since 1997; Vice President - Claims for 25 years prior thereto
Robert G. Shenk	46	Senior Vice President - Claims since 1997; Vice President - Claims for five years prior thereto
William H. Shupert	72	Senior Vice President - Underwriting since 1991; Vice President - Underwriting for 18 years prior thereto
Daniel J. Wagner	38	Treasurer since 1993; Controller for five years prior thereto

PART II

Item 5. Market for the Registrant's Common Equity and Related Stockholder Matters.

The response to this Item is incorporated in part by reference to page 33 of the Company's Annual Report to Stockholders for the year ended December 31, 1998, which is included as Exhibit (13) to this Form 10-K Report. As of March 15, 1999, the Company had approximately 566 holders of record of its Common Stock. The Company declared dividends of $.2925 per share in 1997 and $.3375 per share in 1998.

Item 6. Selected Financial Data.

The response to this Item is incorporated by reference to page 1 of the Company's Annual Report to Stockholders for the year ended December 31, 1998, 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 12 through 15 of the Company's Annual Report to Stockholders for the year ended December 31, 1998, which is included as Exhibit (13) to this Form 10-K Report.

Item 8. Financial Statements and Supplementary Data.

The response to this Item is incorporated by reference to pages 16 through 30 of the Company's Annual Report to Stockholders for the year ended December 31, 1998, 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.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The response to this Item with respect to the Company's directors is incorporated by reference to pages 7 through 10 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 15, 1999. The response to this Item with respect to the Company's executive officers is incorporated by reference to Part I of this Form 10-K Report.

Item 11. Executive Compensation.

The response to this Item is incorporated by reference to pages 10 through 15 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 15, 1999, except for the Compensation Committee Report and the Performance Graph, which are not incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

The response to this Item is incorporated by reference to pages 2 through 4 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 15, 1999.

Item 13. Certain Relationships and Related Transactions.

The response to this Item is incorporated by reference to pages 4 through 6 and page 14 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 15, 1999.

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K.

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

(1) Consolidated Financial Statements

(2) Financial Statement Schedules

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

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* Refers to the respective page of Donegal Group Inc.'s 1998 Annual Report to Stockholders. The Consolidated Financial Statements and Notes to Consolidated Financial Statements and Auditor's Report thereon on pages 16 through 31 are incorporated herein by reference. With the exception of the portions of such Annual Report specifically incorporated by reference in this Item and Items 5, 6, 7 and 8, 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 Securities Exchange Act of 1934.

(3) Exhibits

Exhibit No.	Description of Exhibits	Reference
(3)(i)	Certificate of Incorporation of Registrant	(a)
(3)(ii)	Amended and Restated By-laws of Registrant	(b)
(4)	Form of Registrant's Common Stock Certificate	(a)
Management Contracts and Compensatory Plans or Arrangements		
(10)(A)	Donegal Mutual Insurance Company Money Purchase Pension Plan and Trust dated March 12, 1985	(a)
(10)(B)	Donegal Mutual Insurance Company Profit Sharing Plan and Trust dated March 12, 1985	(a)
(10)(C)	Donegal Group Inc. Key Executive Incentive Bonus Plan dated September 29, 1986	(c)
(10)(D)	Donegal Group Inc. Employee Stock Purchase Plan, as amended	(c)
(10)(E)	Donegal Group Inc. Equity Incentive Plan, as amended	(c)
(10)(F)	Donegal Group Inc. Agency Stock Purchase Plan	(j)
(10)(G)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan	filed herewith
(10)(H)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan for Directors	(i)

(10)(I)	Donegal Group Inc. Executive Restoration Plan	(b)

Other Material Contracts

(10)(J)	Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company	(a)
(10)(K)	Services Allocation Agreement dated September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company	(a)
(10)(L)	Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(a)
(10)(M)	Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(d)
(10)(N)	Multi-Line Excess of Loss Reinsurance Agreement effective January 1, 1993 between Donegal Mutual Insurance Company, Southern Insurance Company of Virginia, Atlantic States Insurance Company and Pioneer Mutual Insurance Company, and Christiana General Insurance Corporation of New York, Cologne Reinsurance Company of America, Continental Casualty Company, Employers Reinsurance Corporation and Munich American Reinsurance Company	(f)
(10)(O)	Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(e)
(10)(P)	Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(g)

(10)(Q)	Credit Agreement dated as of December 29, 1995 between Donegal Group Inc. and Fleet National Bank of Connecticut	(g)
(10)(R)	Stock Purchase Agreement dated as of December 21, 1995 between Donegal Mutual Insurance Company and Donegal Group Inc.	(g)
(10)(S)	Donegal Group Inc. 1996 Employee Stock Purchase Plan	(h)
(10)(T)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Pioneer Insurance Company	(b)
(10)(U)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Delaware American Insurance Company	(b)
(10)(V)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia	(b)
(10)(W)	Stock Purchase Agreement dated as of May 14, 1998 between Donegal Group Inc. and Southern Heritage Limited Partnership	(k)
(10)(X)	Amendment dated November 17, 1998 to Stock Purchase Agreement dated as of May 14, 1998 between Donegal Group Inc. and Southern Heritage Limited Partnership	(k)
(10)(Y)	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	(k)
(13)	1998 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K report)	filed herewith
(20)	Proxy Statement relating to the Annual Meeting of Stockholders to be held on	(l)

April 15, 1999, provided, however, that the Compensation Committee Report and the Performance Graph shall not be deemed filed as part of this Form 10-K Report

(21)	Subsidiaries of Registrant	filed herewith
(23)	Consent of Independent Auditors	filed herewith
(27)	Financial Data Schedule	filed herewith

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

(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, 1996.

(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, 1986.

(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, 1988.

(e) 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.

(f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 33-67346 declared effective September 29, 1993.

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

(h) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-8 Registration Statement No. 333-1287 filed February 29, 1996.

(i) 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, 1997.

(j) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 333-06787 declared effective August 1, 1996.

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

(l) Such exhibit is hereby incorporated by reference to the Registrant's definitive proxy statement filed March 22, 1999.

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE I - SUMMARY OF INVESTMENTS
OTHER THAN INVESTMENTS IN RELATED PARTIES

December 31, 1998

	Cost	Fair Value	Amount at Which Shown in the Balance Sheet
Fixed Maturities:			
Held to maturity:			
United States government and governmental agencies and authorities including obligations of states and political subdivisions.....	$ 99,832	$103,766	$ 99,832
All other corporate bonds....................	9,131	9,550	9,131
Mortgage-backed securities...............	18,221	18,317	18,221
Total fixed maturities held to maturity..........	127,184	131,633	127,184
Available for sale:			
United States government and governmental agencies and authorities including obligations of states and political subdivisions..............	74,116	75,397	75,396
All other corporate bonds....................	10,643	10,787	10,787
Mortgage-backed securities...............	4,331	4,342	4,342
Total fixed maturities available for sale........	89,090	90,526	90,525
Total fixed maturities.....	216,274	222,159	217,709
Equity Securities:			
Preferred stocks			
Public utilities..........	250	250	250
Banks.....................	2,713	2,801	2,801
Industrial and miscellaneous............	987	1,022	1,022
Total preferred stocks.....	3,950	4,073	4,073
Common stocks			
Public utilities..........	57	56	56
Banks and insurance companies................	308	852	852
Industrial and miscellaneous............	1,892	1,783	1,783
Total common stocks........	2,257	2,691	2,691
Total equity securities....	6,207	6,764	6,764
Short-term investments.......	30,522	30,522	30,522
Total investments..........	$253,003	$259,445	$254,995

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

Condensed Balance Sheets
($ in thousands)
December 31, 1998 and 1997

ASSETS

	1998	1997
Investment in subsidiaries (equity method)	$134,441	$ 99,857
Short-term investments, at cost, which approximates market	3	3
Cash	599	730
Property and equipment	2,276	2,139
Goodwill	121	--
Current income taxes	568	243
Loan costs	254	205
Other receivables	1,178	--
Total assets	$139,440	$103,177

LIABILITIES AND STOCKHOLDERS' EQUITY

	1998	1997
Cash dividends declared to stockholders	$ 708	$ 604
Accounts payable and accrued expenses	277	208
Deferred income taxes	324	268
Line of credit	37,500	10,500
Total liabilities	38,809	11,580
Stockholders' equity		
Preferred stock, $1.00 par value, authorized 1,000,000 shares, none issued		
Common stock, $1.00 par value, authorized 15,000,000 shares, issued 8,325,221 and 6,122,431 shares and outstanding 8,202,933 and 6,030,715 shares	8,325	6,123
Additional paid-in capital	41,271	38,932
Accumulated other comprehensive income		
Retained earnings, including equity in undistributed net income of subsidiaries	1,316	1,012
($64,922 and $56,082)	50,611	46,422
Treasury stock, at cost	(892)	(892)
Total stockholders' equity	100,631	91,597
Total liabilities and stockholders' equity	$139,440	$103,177

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

Condensed Statements of Income
($ in thousands)

Years ended December 31, 1998, 1997 and 1996

	1998	1997	1996
Revenues			
Dividends-subsidiary	$1,000	$950	$ 0
Lease income	754	643	541
Investment income	22	15	31
Total revenues	1,776	1,608	572
Expenses			
Operating Expenses	718	643	548
Interest	1,293	1,022	416
Total expenses	2,011	1,665	964
Loss before income tax benefit and equity in undistributed net income of subsidiaries	(235)	(57)	(392)
Income tax benefit	(413)	(346)	(533)
Income before equity in undistributed net income of subsidiaries	178	289	141
Equity in undistributed net income of subsidiaries	8,840	10,352	8,417
Net income	$9,018	$10,641	$8,558

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED INFORMATION OF PARENT COMPANY

Condensed Statements of Cash Flows
($ in thousands)
Years ended December 31, 1998, 1997 and 1996

	1998	1997	1996
Cash flows from operating activities:			
Net income	$ 9,018	$ 10,641	$ 8,558
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(8,840)	(10,352)	(8,417)
Change in accounts payable and accrued expenses	35	34	(143)
Depreciation and amortization	491	401	309
Change in deferred income tax	56	2	16
Change in current income tax receivable	(325)	(85)	183
Change in other receivables	(1,178)	30	8
Net adjustments	(9,761)	(9,970)	(8,044)
Net cash provided by (used in) operating activities	(743)	671	514
Cash flows from investing activities:			
Net sales (purchases) of short-term investments	(5,280)	4	1,110
Net purchase of property and equipment	(564)	(1,251)	(203)
Capital contribution to subsidiaries	(2,000)	---	(5,000)
Acquisition of Southern Heritage	(18,361)	---	---
Acquisition of Delaware Atlantic	---	---	(202)
Net cash provided by (used in) investing activities	(26,205)	(1,247)	(4,295)
Cash flows from financing activities:			
Cash dividends paid	(2,664)	(2,252)	(1,879)
Issuance of common stock	2,481	1,131	2,512
Purchase of treasury stock	---	---	(72)
Line of credit, net	27,000	2,000	3,500
Net cash provided by (used in) financing activities	26,817	879	4,061
Net change in cash	(131)	303	280
Cash beginning	730	427	147
Cash ending	$ 599	$ 730	$ 427

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION

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, 1998						
Personal Lines	$ 71,676	$ ---	$49,141	$12,614	$14,052	$ 73,070
Commercial Lines	44,493	---	24,026	6,876	7,660	45,084
Investments	---	11,998	---	---	---	---
	$116,169	$11,998	$73,167	$19,490	$21,712	$118,154
Year Ended December 31, 1997						
Personal Lines	$ 61,600	$ ---	$41,074	$11,578	$10,564	$ 63,525
Commercial Lines	45,702	---	26,583	7,118	6,495	44,081
Investments	---	11,507	---	---	---	---
	$107,302	$11,507	$67,657	$18,696	$17,059	$107,606
Year Ended December 31, 1996						
Personal Lines	$ 58,356	$ ---	$45,822	$10,286	$ 9,588	$ 60,788
Commercial Lines	46,171	---	24,599	6,746	6,289	48,427
Investments	---	10,799	---	---	---	---
	$104,527	$10,799	$70,421	$17,032	$15,877	$109,215

(continued)

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION

Segment	Deferred Policy Acquisition Costs	Liability for Losses and Loss Expenses	Unearned Premiums	At December 31, Other Policy Claims and Benefits Payable
1998				
Personal Lines	$ 7,648	$ 77,482	$63,916	$ --
Commercial Lines	3,686	63,927	30,807	--
Investments	--	--	--	--
	$11,334	$141,409	$94,723	$ --
1997				
Personal Lines	$ 4,732	$ 54,309	$39,972	$ --
Commercial Lines	3,716	63,803	31,396	--
Investments	--	--	--	--
	$ 8,448	$118,112	$71,368	$ --

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE IV - REINSURANCE

	Gross Amount	Ceded to Other Companies	Assumed from Other Companies	Net Amount	Percentage Assumed to Net
Year Ended December 31, 1998					
Property and casualty premiums	$61,173,134	$56,338,098	$111,333,956	$116,168,992	96%
Year Ended December 31, 1997					
Property and casualty premiums	$51,753,477	$51,753,477	$107,302,168	$107,302,168	100%
Year Ended December 31, 1996					
Property and casualty premiums	$49,802,516	$41,185,853	$ 95,910,375	$104,527,038	92%

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI - SUPPLEMENTARY INSURANCE INFORMATION
CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES

	Deferred Policy Acquisition Costs	Liability for Losses and Loss Expenses	Discount, if any, Deducted from Reserves	Unearned Premiums
At December 31,				
1998	$11,334,301	$141,409,008	$ ---	$94,722,785
1997	$ 8,448,060	$118,112,390	$ ---	$71,367,691

(continued)

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI - SUPPLEMENTARY INSURANCE INFORMATION
CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES

	Net Earned Premiums	Investment Income	Losses and Loss Expenses Related to (1) Current Year	Losses and Loss Expenses Related to (2) Prior Years	Amortization of Deferred Policy Acquisition Costs	Net Paid Losses and Loss Expenses	Net Premiums Written
Year Ended December 31, 1998	$116,168,992	$11,997,661	$75,463,085	$(2,296,000)	$19,490,000	$71,744,736	$118,153,817
Year Ended December 31, 1997	$107,302,168	$11,492,012	$69,040,518	$(1,384,000)	$18,696,000	$65,610,249	$107,604,989
Year Ended December 31, 1996	$104,527,038	$10,768,518	$73,211,924	$(2,791,000)	$17,032,000	$66,148,749	$109,169,176

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.

Date: March 30, 1999

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

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 30, 1999
/s/ Ralph G. Spontak Ralph G. Spontak	Senior Vice President and Secretary (principal financial and accounting officer)	March 30, 1999
/s/ Robert S. Bolinger Robert S. Bolinger	Director	March 30, 1999
Thomas J. Finley	Director	March , 1999
/s/ Patricia A. Gilmartin Patricia A. Gilmartin	Director	March 30, 1999
/s/ Philip H. Glatfelter, II Philip H. Glatfelter, II	Director	March 30, 1999
/s/ C. Edwin Ireland C. Edwin Ireland	Director	March 30, 1999
R. Richard Sherbahn	Director	March , 1999

EXHIBIT INDEX
(Pursuant to Item 601 of Regulation S-K)

Exhibit No.	Description of Exhibits	Reference
(3)(i)	Certificate of Incorporation of Registrant	(a)
(3)(ii)	Amended and Restated By-laws of Registrant	(b)
(4)	Form of Registrant's Common Stock Certificate	(a)
Management Contracts and Compensatory Plans or Arrangements		
(10)(A)	Donegal Mutual Insurance Company Money Purchase Pension Plan and Trust dated March 12, 1985	(a)
(10)(B)	Donegal Mutual Insurance Company Profit Sharing Plan and Trust dated March 12, 1985	(a)
(10)(C)	Donegal Group Inc. Key Executive Incentive Bonus Plan dated September 29, 1986	(c)
(10)(D)	Donegal Group Inc. Employee Stock Purchase Plan, as amended	(c)
(10)(E)	Donegal Group Inc. Equity Incentive Plan, as amended	(c)
(10)(F)	Donegal Group Inc. Agency Stock Purchase Plan	(j)
(10)(G)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan	filed herewith
(10)(H)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan for Directors	(i)
(10)(I)	Donegal Group Inc. Executive Restoration Plan	(b)

Other Material Contracts

(10)(J)	Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company	(a)
(10)(K)	Services Allocation Agreement dated September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company	(a)
(10)(L)	Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(a)
(10)(M)	Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(d)
(10)(N)	Multi-Line Excess of Loss Reinsurance Agreement effective January 1, 1993 between Donegal Mutual Insurance Company, Southern Insurance Company of Virginia, Atlantic States Insurance Company and Pioneer Mutual Insurance Company, and Christiana General Insurance Corporation of New York, Cologne Reinsurance Company of America, Continental Casualty Company, Employers Reinsurance Corporation and Munich American Reinsurance Company	(f)
(10)(O)	Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(e)
(10)(P)	Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(g)
(10)(Q)	Credit Agreement dated as of December 29, 1995 between Donegal Group Inc. and Fleet National Bank of Connecticut	(g)

(10)(R)	Stock Purchase Agreement dated as of December 21, 1995 between Donegal Mutual Insurance Company and Donegal Group Inc.	(g)
(10)(S)	Donegal Group Inc. 1996 Employee Stock Purchase Plan	(h)
(10)(T)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Pioneer Insurance Company	(b)
(10)(U)	Reinsurance and Retrocession Agree- ment dated May 21, 1996 between Donegal Mutual Insurance Company and Delaware American Insurance Company	(b)
(10)(V)	Reinsurance and Retrocession Agree- ment dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia	(b)
(10)(W)	Stock Purchase Agreement dated as of May 14, 1998 between Donegal Group Inc. and Southern Heritage Limited Partnership	(k)
(10)(X)	Amendment dated November 17, 1998 to Stock Purchase Agreement dated as of May 14, 1998 between Donegal Group Inc. and Southern Heritage Limited Partnership	(k)
(10)(Y)	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	(k)
(13)	1998 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K report)	filed herewith

(20)	Proxy Statement relating to the Annual Meeting of Stockholders to be held on April 15, 1999, provided, however, that the Compensation Committee Report and the Performance Graph shall not be deemed filed as part of this Form 10-K Report	(l)
(21)	Subsidiaries of Registrant	filed herewith
(23)	Consent of Independent Auditors	filed herewith
(27)	Financial Data Schedule	filed herewith

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(a) 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.

(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, 1996.

(c) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form 10-K Report for the year ended December 31, 1986.

(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, 1988.

(e) 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.

(f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 33-67346 declared effective September 29, 1993.

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

(h) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-8 Registration Statement No. 333-1287 filed February 29, 1996.

(i) 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, 1997.

(j) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 333-06787 declared effective August 1, 1996.

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

(l) Such exhibit is hereby incorporated by reference to the Registrant's definitive proxy statement filed March 22, 1999.

Exhibit 10.g

DONEGAL GROUP INC.

AMENDED AND RESTATED
1996 EQUITY INCENTIVE PLAN

1. Purpose. The purpose of the Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan (the "Plan") is to further the growth, development and financial success of Donegal Group Inc. (the "Company"), its parent and the subsidiaries of the Company and its parent by providing additional incentives to those officers and key employees who are responsible for the management of the business affairs of the Company, its parent and/or subsidiaries of the Company or its parent, which will enable them to participate directly in the growth of the capital stock of the Company. The Company intends that the Plan will facilitate securing, retaining and motivating management employees of high caliber and potential. To accomplish these purposes, the Plan provides a means whereby management employees may receive stock options ("Options") to purchase the Company's Common Stock, $1.00 par value (the "Common Stock").

2. Administration.

(a) Composition of the Committee. The Plan shall be administered by a committee (the "Committee"), which shall be appointed by, and serve at the pleasure of, the Company's Board of Directors (the "Board"). The Committee shall be comprised of two or more members of the Board, each of whom shall be a "non-employee director" within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934 (the "Exchange Act"). In addition, each member of the Committee shall be an "outside director" within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"). Subject to the foregoing, from time to time the Board may increase or decrease the size of the Committee, appoint additional members thereof, remove members (with or without cause), appoint new members, fill vacancies or remove all members of the Committee and thereafter directly administer the Plan.

(b) Authority of the Committee. The Committee shall have full and final authority, in its sole discretion, to interpret the provisions of the Plan and to decide all questions of fact arising in its application; to determine the employees to whom Options shall be granted and the type, amount, size and terms of each such grant; to determine the time when Options shall be granted; and to make all other determinations necessary or advisable for the administration of the Plan. All decisions, determinations and interpretations of the Committee shall be final and binding on all optionees and all other holders of Options granted under the Plan.

(c) Authority of the Board. Notwithstanding anything to the contrary set forth in the Plan, all authority granted hereunder to the Committee may be exercised at any time and from time to time by the Board at its election. All decisions, determinations and interpretations of the Board shall be final and binding on all optionees and all other holders of Options granted under the Plan.

3. Stock Subject to the Plan. Subject to Section 16 hereof, the shares that may be issued under the Plan shall not exceed in the aggregate 1,800,000

shares of Common Stock. Such shares may be authorized and unissued shares or shares issued and subsequently reacquired by the Company. Except as otherwise provided herein, any shares subject to an Option that for any reason expires or is terminated unexercised as to such shares shall again be available under the Plan.

4. Eligibility To Receive Options. Persons eligible to receive Options under the Plan shall be limited to those officers and other key employees of the Company, its parent and any subsidiary of the Company or its parent (as defined in Section 425 of the Code or any amendment or substitute thereto) who are in positions in which their decisions, actions and counsel significantly impact upon the profitability and success of the Company, its parent or any subsidiary of the Company or its parent. Directors of the Company who are not also officers or employees of the Company, its parent or any subsidiary of the Company or its parent shall not be eligible to participate in the Plan. Notwithstanding anything to the contrary set forth in the Plan, the maximum number of shares of Common Stock for which Options may be granted to any employee in any calendar year shall be 100,000 shares.

5. Types of Options. Grants may be made at any time and from time to time by the Committee in the form of stock options to purchase shares of Common Stock. Options granted hereunder may be Options that are intended to qualify as incentive stock options within the meaning of Section 422 of the Code or any amendment or substitute thereto ("Incentive Stock Options") or Options that are not intended to so qualify ("Nonqualified Stock Options").

6. Option Agreements. Options for the purchase of Common Stock shall be evidenced by written agreements in such form not inconsistent with the Plan as the Committee shall approve from time to time. The Options granted hereunder may be evidenced by a single agreement or by multiple agreements, as determined by the Committee in its sole discretion. Each option agreement shall contain in substance the following terms and conditions:

(a) Type of Option. Each option agreement shall identify the Options represented thereby either as Incentive Stock Options or Nonqualified Stock Options, as the case may be.

(b) Option Price. Each option agreement shall set forth the purchase price of the Common Stock purchasable upon the exercise of the Option evidenced thereby. Subject to the limitation set forth in Section 6(d)(ii) of the Plan, the purchase price of the Common Stock subject to an Incentive Stock Option shall be not less than 100% of the fair market value of such stock on the date the Option is granted, as determined by the Committee, but in no event less than the par value of such stock. The purchase price of the Common Stock subject to a Nonqualified Stock Option shall be not less than 100% of the fair market value of such stock on the date the Option is granted, as determined by the Committee. For this purpose, fair market value on any date shall mean the closing price of the Common Stock, as reported in The Wall Street Journal, or if not so reported, as otherwise reported by the National Association of Securities Dealers Automated Quotation ("Nasdaq"), or if the Common Stock is not reported by Nasdaq, the fair market value shall be as determined by the Committee pursuant to Section 422 of the Code.

(c) Exercise Term. Each option agreement shall state the period or periods of time within which the Option may be exercised, in whole or in part, as determined by the Committee, provided that no Option shall be exercisable after ten years from the date of grant thereof. The Committee shall have the power to permit an acceleration of previously established exercise terms, subject to the requirements set forth herein, upon such circumstances and subject to such terms and conditions as the Committee deems appropriate.

(d) Incentive Stock Options. In the case of an Incentive Stock Option, each option agreement shall contain such other terms, conditions and provisions as the Committee determines to be necessary or desirable in order to qualify such Option as a tax-favored Option (within the meaning of Section 422 of the Code or any amendment or substitute thereto or regulation thereunder) including without limitation, each of the following, except that any of these provisions may be omitted or modified if it is no longer required in order to have an Option qualify as a tax-favored Option within the meaning of Section 422 of the Code or any substitute therefor:

(i) The aggregate fair market value (determined as of the date the Option is granted) of the Common Stock with respect to which Incentive Stock Options are first exercisable by any employee during any calendar year (under all plans of the Company) shall not exceed $100,000.

(ii) No Incentive Stock Options shall be granted to any employee if at the time the Option is granted to the individual who owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company or its subsidiaries unless at the time such Option is granted the Option price is at least 110% of the fair market value of the stock subject to the Option and, by its terms, the Option is not exercisable after the expiration of five years from the date of grant.

(iii) No Incentive Stock Options shall be exercisable more than three months (or one year, in the case of an employee who dies or becomes disabled within the meaning of Section 72(m)(7) of the Code or any substitute therefor) after termination of employment.

(e) Substitution of Options. Options may be granted under the Plan from time to time in substitution for stock options held by employees of other corporations who are about to become, and who do concurrently with the grant of such options become, employees of the Company, its parent or a subsidiary of the Company or its parent as a result of a merger or consolidation of the employing corporation with the Company, its parent or a subsidiary of the Company or its parent, or the acquisition by the Company, its parent or a subsidiary of the Company or its parent of the assets or capital stock of the employing corporation. The terms and conditions of the substitute options so granted may vary from the terms and conditions set forth in this Section 6 to such extent as the Committee at the time of grant may deem appropriate to conform, in whole or in part, to the provisions of the stock options in substitution for which they are granted.

7. Date of Grant. The date on which an Option shall be deemed to have been granted under the Plan shall be the date of the Committee's authorization of the Option or such later date as may be determined by the Committee at the time the Option is authorized. Notice of the determination shall be given to each individual to whom an Option is so granted within a reasonable time after the date of such grant.

8. Exercise and Payment for Shares. Options may be exercised in whole or in part, from time to time, by giving written notice of exercise to the Secretary of the Company, specifying the number of shares to be purchased. The purchase price of the shares with respect to which an Option is exercised shall be payable in full with the notice of exercise in cash, Common Stock at fair market value, or a combination thereof, as the Committee may determine from time to time and subject to such terms and conditions as may be prescribed by the Committee for such purpose. The Committee may also, in its discretion and subject to prior notification to the Company by an optionee, permit an optionee to enter into an agreement with the Company's transfer agent or a brokerage firm of national standing whereby the optionee will simultaneously exercise the Option and sell the shares acquired thereby through the Company's transfer agent or such a brokerage firm and either the Company's transfer agent or the brokerage firm executing the sale will remit to the Company from the proceeds of sale the exercise price of the shares as to which the Option has been exercised.

9. Rights upon Termination of Employment. In the event that an optionee ceases to be an employee of the Company, its parent or any subsidiary of the Company or its parent for any reason other than death, retirement, as hereinafter defined, or disability (within the meaning of Section 72(m)(7) of the Code or any substitute therefor), the optionee shall have the right to exercise the Option during its term within a period of three months after such termination to the extent that the Option was exercisable at the time of termination, or within such other period, and subject to such terms and conditions, as may be specified by the Committee. In the event that an optionee dies, retires or becomes disabled prior to the expiration of his Option and without having fully exercised his Option, the optionee or his successor shall have the right to exercise the Option during its term within a period of one year after termination of employment due to death, retirement or disability to the extent that the Option was exercisable at the time of termination, or within such other period, and subject to such terms and conditions, as may be specified by the Committee. As used in this Section 9, "retirement" means a termination of employment by reason of an optionee's retirement at or after his earliest permissible retirement date pursuant to and in accordance with his employer's regular retirement plan or personnel practices. Notwithstanding the provisions of Section 6(d)(iii) hereof, if the term of an Incentive Stock Option continues for more than three months after termination of employment due to retirement or more than one year after termination of employment due to death or disability, such Option shall thereupon lose its status as an Incentive Stock Option and shall be treated as a Nonqualified Stock Option.

10. General Restrictions. Each Option granted under the Plan shall be subject to the requirement that, if at any time the Committee shall determine that (i) the listing, registration or qualification of the shares of Common Stock subject or related thereto upon any securities exchange or under any state or federal law, or (ii) the consent or approval of any government regulatory body, or (iii) the satisfaction of any tax payment or withholding obligation, or (iv) an agreement by the recipient of an Option with respect to the disposition of shares of Common Stock, is necessary or desirable as a condition of or in connection with the granting of such Option or the issuance or purchase of shares of Common Stock thereunder, such Option shall not be consummated in whole or in part unless such listing, registration, qualification, consent, approval or agreement shall have been effected or obtained free of any conditions not acceptable to the Committee.

11. Rights of a Stockholder. The recipient of any Option under the Plan, unless otherwise provided by the Plan, shall have no rights as a stockholder unless and until certificates for shares of Common Stock are issued and delivered to him.

12. Right to Terminate Employment. Nothing contained in the Plan or in any option agreement entered into pursuant to the Plan shall confer upon any optionee the right to continue in the employment of the Company, its parent or any subsidiary of the Company or its parent or affect any right that the Company, its parent or any subsidiary of the Company or its parent may have to terminate the employment of such optionee.

13. Withholding. Whenever the Company proposes or is required to issue or transfer shares of Common Stock under the Plan, the Company shall have the right to require the recipient to remit to the Company an amount sufficient to satisfy any federal, state or local withholding tax requirements prior to the delivery of any certificate or certificates for such shares. If and to the extent authorized by the Committee, in its sole discretion, an optionee may make an election, by means of a form of election to be prescribed by the Committee, to have shares of Common Stock that are acquired upon exercise of an Option withheld by the Company or to tender other shares of Common Stock or other securities of the Company owned by the optionee to the Company at the time of exercise of an Option to pay the amount of tax that would otherwise be required by law to be withheld by the Company as a result of any exercise of an Option. Any such election shall be irrevocable and shall be subject to termination by the Committee, in its sole discretion, at any time. Any securities so withheld or tendered will be valued by the Committee as of the date of exercise.

14. Non-Assignability. No Option under the Plan shall be assignable or transferable by the recipient thereof except by will or by the laws of descent and distribution or by such other means as the Committee may approve. During the life of the recipient, such Option shall be exercisable only by such person or by such person's guardian or legal representative.

15. Non-Uniform Determinations. The Committee's determinations under the Plan (including without limitation determinations of the persons to receive Options, the form, amount and timing of such grants, the terms and provisions of Options, and the agreements evidencing same) need not be uniform and may be made selectively among persons who receive, or are eligible to receive, grants of Options under the Plan whether or not such persons are similarly situated.

16. Adjustments.

(a) Changes in Capitalization. Subject to any required action by the stockholders of the Company, the number of shares of Common Stock covered by each outstanding Option and the number of shares of Common Stock that have been authorized for issuance under the Plan but as to which no Options have yet been granted or which have been returned to the Plan upon cancellation or expiration of an Option, as well as the price per share of Common Stock covered by each such outstanding Option, shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, reverse stock split, stock dividend, combination or reclassification of the Common Stock, or any other increase or decrease in the number of issued shares of Common Stock effected without receipt of consideration by the Company; provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been "effected without receipt of consideration." Such adjustment shall be made by the Committee, whose determination in that respect shall be final, binding and conclusive. Except as expressly provided herein, no issuance by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of shares of Common Stock subject to an Option.

(b) Dissolution or Liquidation. In the event of the proposed dissolution or liquidation of the Company, all outstanding Options will terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the Committee. The Committee may, in the exercise of its discretion in such instances, declare that any Option shall terminate as of a date fixed by the Committee and give each Option holder the right to exercise his Option as to all or any part of the shares of Common Stock covered by the Option, including shares as to which the Option would not otherwise be exercisable.

(c) Sale or Merger. In the event of a proposed sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, the Committee, in the exercise of its sole discretion, may take such action as it deems desirable, including, but not limited to: (i) causing an Option to be assumed or an equivalent option to be substituted by the successor corporation or a parent or subsidiary of such successor corporation, (ii) providing that each Option holder shall have the right to exercise his Option as to all of the shares of Common Stock covered by the Option, including shares as to which the Option would not otherwise be exercisable, or (iii) declaring that an Option shall terminate at a date fixed by the Committee provided that the Option holder is given notice and opportunity to exercise the then exercisable portion of his Option prior to such date.

17. Amendment. The Committee may terminate or amend the Plan at any time, with respect to shares as to which Options have not been granted, subject to any required stockholder approval or any stockholder approval that the Board may deem to be advisable for any reason, such as for the purpose of obtaining or retaining any statutory or regulatory benefits under tax, securities or other laws or satisfying any applicable stock exchange listing requirements. The Committee may not, without the consent of the holder of an Option, alter or impair any Option previously granted under the Plan, except as specifically authorized herein.

18. Reservation of Shares. The Company, during the term of the Plan, will at all times reserve and keep available such number of shares as shall be sufficient to satisfy the requirements of the Plan. Inability of the Company to obtain authority from any regulatory body having jurisdiction, which authority is deemed by the Company's counsel to be necessary to the lawful issuance and sale of any shares hereunder, shall relieve the Company of any liability for the failure to issue or sell such shares as to which such requisite authority shall not have been obtained.

19. Effect on Other Plans. Participation in the Plan shall not affect an employee's eligibility to participate in any other benefit or incentive plan of the Company, its parent or any subsidiary of the Company or its parent. Any Options granted pursuant to the Plan shall not be used in determining the benefits provided under any other plan of the Company, its parent or any subsidiary of the Company or its parent unless specifically provided.

20. Duration of the Plan. The Plan shall remain in effect until all Options granted under the Plan have been satisfied by the issuance of shares, but no Option shall be granted more than ten years after the earlier of the date the Plan is adopted by the Company or is approved by the Company's stockholders.

21. Forfeiture for Dishonesty. Notwithstanding anything to the contrary in the Plan, if the Committee finds, by a majority vote, after full consideration of the facts presented on behalf of both the Company and any optionee, that the optionee has been engaged in fraud, embezzlement, theft, commission of a felony or dishonest conduct in the course of his employment or retention by the Company, its parent or any subsidiary of the Company or its parent that damaged the Company, its parent or any subsidiary of the Company or its parent or that the optionee has disclosed confidential information of the Company, its parent or any subsidiary of the Company or its parent, the optionee shall forfeit all unexercised Options and all exercised Options under which the Company has not yet delivered the certificates. The decision of the Committee in interpreting and applying the provisions of this Section 21 shall be final. No decision of the Commit tee, however, shall affect the finality of the discharge or termination of such optionee by the Company, its parent or any subsidiary of the Company or its parent in any manner.

22. No Prohibition on Corporate Action. No provision of the Plan shall be construed to prevent the Company or any officer or director thereof from taking any action deemed by the Company or such officer or director to be appropriate or in the Company's best interest, whether or not such action could have an adverse effect on the Plan or any Options granted hereunder, and no optionee or optionee's estate, personal representative or beneficiary shall have any claim against the Company or any officer or director thereof as a result of the taking of such action.

23. Indemnification. With respect to the administration of the Plan, the Company shall indemnify each present and future member of the Committee and the Board against, and each member of the Committee and the Board shall be entitled without further action on his part to indemnity from the Company for, all expenses (including the amount of judgments and the amount of approved settlements made with a view to the curtailment of costs of litigation, other than amounts paid to the Company itself) reasonably incurred by him in connection with or arising out of, any action, suit or proceeding in which he may be involved by reason of his being or having been a member of the Committee

or the Board, whether or not he continues to be such member at the time of incurring such expenses; provided, however, that such indemnity shall not include any expenses incurred by any such member of the Committee or the Board (i) in respect of matters as to which he shall be finally adjudged in any such action, suit or proceeding to have been guilty of gross negligence or willful misconduct in the performance of his duty as such member of the Committee or the Board; or (ii) in respect of any matter in which any settlement is effected for an amount in excess of the amount approved by the Company on the advice of its legal counsel; and provided further that no right of indemnification under the provisions set forth herein shall be available to or enforceable by any such member of the Committee or the Board unless, within 60 days after institution of any such action, suit or proceeding, he shall have offered the Company in writing the opportunity to handle and defend same at its own expense. The foregoing right of indemnification shall inure to the benefit of the heirs, executors or administrators of each such member of the Committee or the Board and shall be in addition to all other rights to which such member may be entitled as a matter of law, contract or otherwise.

24. Miscellaneous Provisions.

(a) Compliance with Plan Provisions. No optionee or other person shall have any right with respect to the Plan, the Common Stock reserved for issuance under the Plan or in any Option until a written option agreement shall have been executed by the Company and the optionee and all the terms, conditions and provisions of the Plan and the Option applicable to such optionee (and each person claiming under or through him) have been met.

(b) Approval of Counsel. In the discretion of the Committee, no shares of Common Stock, other securities or property of the Company or other forms of payment shall be issued hereunder with respect to any Option unless counsel for the Company shall be satisfied that such issuance will be in compliance with applicable federal, state, local and foreign legal, securities exchange and other applicable requirements.

(c) Compliance with Rule 16b-3. To the extent that Rule 16b-3 under the Exchange Act applies to the Plan or to Options granted under the Plan, it is the intention of the Company that the Plan comply in all respects with the requirements of Rule 16b-3, that any ambiguities or inconsistencies in construction of the Plan be interpreted to give effect to such intention and that, if the Plan shall not so comply, whether on the date of adoption or by reason of any later amendment to or interpretation of Rule 16b-3, the provisions of the Plan shall be deemed to be automatically amended so as to bring them into full compliance with such rule.

(d) Effects of Acceptance of Option. By accepting any Option or other benefit under the Plan, each optionee and each person claiming under or through him shall be conclusively deemed to have indicated his acceptance and ratification of, and consent to, any action taken under the Plan by the Company, the Board and/or the Committee or its delegates.

(e) Construction. The masculine pronoun shall include the feminine and neuter, and the singular shall include the plural, where the context so indicates.

25. Stockholder Approval. The exercise of any Option granted under the Plan shall be subject to the approval of the Plan by the affirmative vote of the holders of a majority of the outstanding shares of the Common Stock present, or represented, and entitled to vote at a meeting duly held.

Exhibit 13

Financial Highlights

Year Ended December 31, Income statement data	1998	1997	1996	1995	1994
Net premiums earned	$116,168,992	$107,302,168	$104,527,038	$ 89,522,203	$ 79,026,809
Investment income	11,997,661	11,507,277	10,799,369	9,713,744	8,188,852
Total revenues	130,586,365	121,327,606	117,581,664	101,615,698	88,607,550
Net income	9,017,840	10,641,186	8,557,774	9,559,610	4,589,397
Net income per common share					
Basic	1.11	1.33*	1.10*	1.29*	.63*
Diluted	1.09	1.32*	1.09*	1.26*	.62*

Balance sheet data					
Total assets	$385,231,506	$304,104,505	$287,990,994	$244,943,598	$215,013,165
Stockholders' equity	100,631,004	91,596,663	81,599,274	73,020,689	61,338,761
Book value per share	12.27	11.39*	10.26*	9.64*	8.42*

* Restated

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

Donegal Group Inc. ("DGI" or the "Company") is a regional insurance holding company doing business in the Mid-Atlantic and Southern states through its five wholly-owned property-casualty insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Southern Heritage Insurance Company ("Southern Heritage"), Delaware Atlantic Insurance Company ("Delaware") and Pioneer Insurance Company ("Pioneer") (collectively "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. DGI was formed in September 1986 by Donegal Mutual Insurance Company (the "Mutual Company"), which owns 60% of the outstanding common shares of the Company as of December 31, 1998.

On June 25, 1998, the Company issued a 4-for-3 stock split in the form of a 33 1/3% stock dividend to stockholders of record as of June 10, 1998. Per share information prior to June 25, 1998, has been restated for this change.

Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 65% of the pooled business. Southern cedes 50% of its business to the Mutual Company and Delaware cedes 70% of its Workers' Compensation business to the Mutual Company. Because the Mutual Company places substantially all of the business assumed from Southern and Delaware into the pool, from which the Company has a 65% allocation, the Company's results of operations include approximately 83% of the business written by Southern and approximately 76% of the Workers' Compensation business written by Delaware.

In November 1998, the Company acquired all of the outstanding stock of Southern Heritage. This transaction was accounted for as a "purchase." The Company's financial statements include Southern Heritage as a consolidated subsidiary from November 1, 1998.

In addition to the Company's Insurance Subsidiaries, it also owns all of the outstanding stock of Atlantic Insurance Services, Inc. ("AIS"), an insurance services organization currently providing inspection and policy auditing information on a fee-for-service basis to its affiliates and the insurance industry.

Results of Operation 1998 Compared to 1997

Total revenues for 1998 were $130,586,365, which were $9,258,759, or 7.6%, greater than 1997. Net premiums earned increased to $116,168,992, an increase of $8,866,824, or 8.3%, over 1997. The acquisition of Southern Heritage contributed $4,835,036, or 4.5%, to the earned premiums in 1998. Direct premiums written by the combined pool of Atlantic States and the Mutual Company increased $6,426,444 or 4.7%. A 17.5% increase in the direct premiums written of Southern, a 6.5% decrease in the direct premiums written of Delaware and an 11.7% decrease in the direct premiums written of Pioneer accounted for the majority of the remaining change. The Company reported realized investment losses of $13,562, compared to realized investment gains of $314,136 in 1997. Realized gains and losses in both years resulted from normal turnover of the Company's investment portfolio. As of December 31, 1998, 99.9% of the Company's bond portfolio was classified as Class 1 (highest quality) by the National Association of Insurance Commissioners' Securities Valuation Office. Investment income increased $490,384. An increase in the average invested assets from $198,727,027 to $208,303,664, offset by a decrease in the average yield to 5.6% from 5.8% in 1997, accounted for the change.

The GAAP combined ratio of insurance operations was 99.8% in 1998, compared to 97.6% in 1997. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjustment expenses to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in 1998 was 63.0%, compared to 63.1% in 1997. The expense ratio for 1998 was 35.4%, compared to 33.3% in 1997, with the dividend ratio increasing from 1.2% in 1997 to 1.4% in 1998. The increase in the Company's expense ratio accounted for the change in its combined ratio. The expense ratio was adversely affected by a charge to earnings in the third quarter resulting from an unprecedented large mandatory Pennsylvania Insurance Guaranty Association assessment arising from the insolvency of two medical malpractice companies. The Company's share of the Guaranty Association liability arising from these two companies was

$1.3 million. Guaranty Association assessments represent mandatory regulatory charges that must be absorbed by substantially all property and casualty insurance companies doing business in a state where an insolvent company had been writing business, including companies, like Donegal, who do not write lines of business that the insolvent companies were writing.

Results of Operation 1997 Compared to 1996

Total revenues for 1997 were $121,327,606 which were $3,745,942, or 3.2%, greater than 1996. Net premiums earned increased to $107,302,168, an increase of $2,775,130, or 2.7%, over 1996. Direct premiums written by the combined pool of Atlantic States and the Mutual Company decreased $107,786, with Workers' Compensation decreasing $4,052,981, or 19.5%, due to a mandatory rate rollback for that line in Pennsylvania. A 12.4% increase in the direct premiums written of Southern, a 6.6% increase in the direct premiums written of Delaware and an 18.5% decrease in the direct premiums written of Pioneer accounted for the majority of the remaining increase. The Company reported realized investment gains of $314,136, compared to realized investment gains of $172,734 in 1996. Gains in both years resulted from normal turnover of the Company's investment portfolio. As of December 31, 1997, 99.9% of the Company's bond portfolio was classified as Class 1 (highest quality) by the National Association of Insurance Commissioners' Securities Valuation Office. Investment income increased $707,908. An increase in the average invested assets from $180,352,394 to $198,727,027, offset by a decrease in the average yield to 5.8% from 6.0% in 1996, accounted for the change.

The GAAP combined ratio of insurance operations was 97.6% in 1997, compared to 100.4% in 1996. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjustment expenses to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in 1997 was 63.1%, compared to 67.4% in 1996, accounting for the majority of the change in the combined ratio. This decrease in the loss ratio resulted from a return to more normal weather patterns in 1997, compared to severe winter weather experienced in the primary operating areas of the Company in the first quarter of 1996. The expense ratio for 1997 was 33.3%, compared to 31.5% in 1996, with the dividend ratio decreasing from 1.5% in 1996 to 1.2% in 1997 due primarily to the rate rollback in Workers' Compensation in 1997.

Liquidity and Capital Resources

The Company generates sufficient funds from its operations and maintains a high degree of liquidity in its investment portfolio. The primary source of funds to meet the demands of claim settlements and operating expenses are premium collections, investment earnings and maturing investments. As of December 31, 1998, the Company had no material commitment for capital expenditures.

In investing funds made available from operations, the Company maintains securities' maturities consistent with its projected cash needs for the payment of claims and expenses. The Company maintains a portion of its investment portfolio in relatively short-term and highly liquid assets to ensure the availability of funds.

As of December 31, 1998, pursuant to a credit agreement dated December 29, 1995, with Fleet National Bank of Connecticut, the Company had unsecured borrowings of $37.5 million. Such borrowings were made in connection with the acquisitions of Delaware, Pioneer and Southern Heritage and various capital contributions to the subsidiaries. Per the terms of the credit agreement, the Company may borrow up to $40 million at interest rates equal to the bank's then current prime rate or the then current London interbank Eurodollar bank rate plus 1.70%. At December 31, 1998, the interest rates on the outstanding balances were 7.75% on an outstanding prime rate balance of $22.5 million and 6.93375% on an outstanding Eurodollar rate balance of $15 million. In addition, the Company pays a rate of 3/10 of 1% per annum on the average daily unused portion of the bank's commitment. On each July 27, commencing July 27, 2001, the credit line will be reduced by $8 million. Any outstanding loan in excess of the remaining credit line after such reduction will then be payable.

The Company's principal sources of cash with which to meet obligations and pay stockholder dividends are dividends from the Insurance Subsidiaries which 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. The Insurance Subsidiaries are also subject to Risk Based Capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 1998, all five companies' statutory capital and surplus were substantially above the RBC requirements. At December 31, 1998, amounts available for distribution as dividends to DGI without prior approval of the insurance regulatory authorities were $6,480,524 from Atlantic States, $638,832 from Southern, $1,085,807 from Delaware, $530,035 from Pioneer and $1,580,564 from Southern Heritage.

Net unrealized gains resulting from fluctuations in the fair value of investments reported in the balance sheet at fair value were $1,315,425 (net of applicable federal income tax) at December 31, 1998, and $1,011,417 (net of applicable federal income tax) at December 31, 1997.

Credit Risk

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

The Company's Insurance Subsidiaries have reinsurance agreements in place with the Mutual Company, as described in Note 3 of the financial statements, and with a number of other major authorized reinsurers, as described in Note 9 of the financial statements.

Impact of Inflation

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

Year 2000 Issues

The Year 2000 issue (i.e. the ability of computer systems to properly process information which contains dates beginning with January 1, 2000 and thereafter) affects virtually all companies. All computer systems used for processing of business for the Company are owned and operated by the Mutual Company.

The ability to process information in a timely and accurate manner is vital to the Company's property and casualty insurance business. The Company recognizes that the systems used to process its business must be able to accurately identify and process information containing year 2000 dates. The Mutual Company has had a vigorous and comprehensive project underway since 1995 to ensure substantial compliance by the end of 1998. This project was initiated as part of a review of the main application systems utilized by the Mutual Company and was geared towards the implementation of new or current versions of its applications software to bring greater efficiencies and operational improvements to its users. The project was expanded to include a review of all hardware, peripheral software and inquiries of agents and vendors to determine the readiness of each related to the Year 2000 problem. During 1998 the Mutual Company put into production its updated, Year-2000-compliant versions of its main application softwares and late in the year began issuing policies with expiration dates in the year 2000. The implementations of these updated systems were without major problems and the Mutual Company's mission-critical systems were substantially Year-2000-compliant by the end of 1998. Testing of less critical systems, documentation of vendors' readiness and final testing of certain other potential problem dates will continue during the first half of 1999. Costs directly related to Year 2000 changes were not material.

With respect to insurance policies issued by the Company providing coverages to insureds who may incur losses as a result of Year 2000 problems, the Company is evaluating its possible exposure under such coverages. Endorsements excluding losses related to or resulting from Year 2000 issues are being attached to commercial policies.

Given the nature of its business, the Company believes that its exposure to embedded chip Year 2000 issues is minimal. The Company believes that its most significant Year 2000 exposure is the potential business disruption that would be caused by widespread failure of public utility systems. Prolonged failure of power and telecommunications systems could have a material adverse effect on the Company's results of operations, cash flows and consolidated financial position.

This Year 2000 disclosure contains statements which are forward-looking statements that involve risks and uncertainties and qualify for the statutory safe harbor under the Private Securities Litigation Reform Act of 1995. Future Year 2000 readiness activities may not adhere to the anticipated schedule because more problems may be encountered than anticipated in the various stages of testing and trained personnel may not be available to work on internal systems in the time required; or there may be unexpected problems with the readiness of third party business partners and vendors who cannot produce services, or utility companies may not be able to provide the vital services required to maintain operations.

Impact of New Accounting Standards

Accounting for Derivative Instruments and for Hedging Activities

Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and for Hedging Activities," requires enterprises to record derivatives on the balance sheet at fair value and establishes special accounting for the following three different types of hedges: hedges of changes in the fair value of assets, liabilities or firm commitments; hedges of the variable cash flows of forecasted transactions; and hedges of foreign currency exposures of net investments in foreign operations. SFAS No. 133 is effective for years beginning after June 15, 1999, with earlier adoption permitted. The Company believes that the effect of adoption of SFAS No. 133 will not be material.

Accounting by Insurance and Other Enterprises for Insurance-Related Assessments

In 1997, the AICPA issued Statement of Position (SOP) 97-3, "Accounting by Insurance and Other Enterprises for Insurance-Related Assessments," which provides guidance for determining when to recognize, and how to determine, a liability for guaranty-fund and other insurance-related assessments. SOP 97-3 is effective for financial statements issued for fiscal years beginning after December 15, 1998. The Company expects to adopt this SOP on January 1, 1999 and currently believes that the cumulative effect of this change in accounting principle will not be material.

Accounting for Costs of Computer Software Developed or Obtained for Internal Use

In March 1998, the AICPA issued SOP 98-1, "Accounting for Costs of Computer Software Developed or Obtained for Internal Use." This SOP requires that certain costs related to the development or purchase of internal-use software be capitalized and amortized over the estimated useful life of the software. This SOP also requires that costs related to the preliminary project stage and the post-implementation/operations stage in an internal-use computer software development project be expensed as incurred. SOP 98-1 is effective for financial statements issued for fiscal years beginning after December 15, 1998. The Company expects to adopt this SOP on January 1, 1999 and is currently assessing its impact on the Company's financial reporting.

Quantitative and Qualitative Disclosure About Market Risk

Interest Rate Risk

The Company's exposure to market risk for changes in interest rates is concentrated in its investment portfolio and, to a lesser extent, its debt obligations. The Company monitors 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 modeled regularly.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 1998 are as follows:

	Principal Cash Flows	Weighted-Average Interest Rate
Fixed maturities and short-term investments:		
1999	$ 47,671,887	5.78%
2000	18,010,000	5.79%
2001	14,625,261	6.87%
2002	9,911,162	6.07%
2003	13,100,000	5.71%
Thereafter	141,981,802	5.82%
Total	$245,300,112	
Market value	$252,681,041	
Debt		
1999	$ 0	7.42%
2000	0	7.42%
2001	5,500,000	7.42%
2002	8,000,000	7.42%
2003	8,000,000	7.42%
Thereafter	16,000,000	7.42%
Total	$ 37,500,000	
Fair value	$ 37,500,000	

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

Equity Price Risk

The Company's portfolio of equity securities, which is carried on the balance sheet at market value, has exposure to price risk. Price risk is defined as the potential loss in market value resulting from an adverse change in prices. Portfolio characteristics are analyzed regularly and market risk is actively managed through a variety of techniques. The portfolio is diversified across industries, and concentrations in any one company or industry are limited by parameters established by management.

The combined total of realized and unrealized equity investment gains and (losses) were ($307,147), $586,178, and $199,733 in 1998, 1997 and 1996, respectively. During these three years the largest total equity investment gain and (loss) in a quarter was $897,971 and ($1,435,101), respectively.

Donegal Group Inc.
Consolidated Balance Sheets

Year Ended December 31,	1998	1997
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value $131,633,299 and $120,882,886)	$127,183,788	$117,246,205
Available for sale, at fair value (amortized cost $89,089,995 and $56,922,342)	90,525,855	57,731,251
Equity securities, available for sale, at fair value (cost $6,206,735 and $6,551,020)	6,763,943	7,274,562
Short-term investments, at cost, which approximates fair value	30,521,887	22,712,787
Total investments	254,995,473	204,964,805
Cash	8,227,042	3,413,315
Accrued investment income	3,164,599	2,741,207
Premiums receivable	19,824,894	11,244,628
Reinsurance receivable	48,339,223	40,953,032
Deferred policy acquisition costs	11,334,301	8,448,060
Federal income taxes receivable	227,841	56,454
Deferred tax asset, net	3,536,692	3,302,043
Prepaid reinsurance premiums	27,203,111	22,882,283
Property and equipment, net	5,920,420	4,938,524
Accounts receivable--securities	329,299	456,493
Due from affiliate	--	141,313
Other	2,128,611	562,348
Total assets	$385,231,506	$304,104,505
Liabilities and Stockholders' Equity		
Liabilities		
Losses and loss expenses	$141,409,008	$118,112,390
Unearned premiums	94,722,785	71,367,691
Accrued expenses	4,821,594	3,214,767
Drafts payable	1,394,373	--
Reinsurance balances payable	1,785,914	735,009
Cash dividend declared to stockholders	708,513	604,054
Borrowings under line of credit	37,500,000	10,500,000
Accounts payable--securities	503,840	2,499,059
Due to affiliate - Pioneer acquisition	--	5,191,774
Due to affiliate - other	870,083	--
Other	884,392	283,098
Total liabilities	284,600,502	212,507,842
Stockholders' Equity		
Preferred stock, $1.00 par value, authorized 1,000,000 shares; none issued		
Common stock, $1.00 par value, authorized 15,000,000 shares, issued 8,325,221 and 6,122,431 shares and outstanding 8,202,933 and 6,030,715 shares	8,325,221	6,122,431
Additional paid-in capital	41,271,322	38,932,117
Accumulated other comprehensive income	1,315,425	1,011,417
Retained earnings	50,610,792	46,422,454
Treasury stock, at cost	(891,756)	(891,756)
Total stockholders' equity	100,631,004	91,596,663
Total liabilities and stockholders' equity	$385,231,506	$304,104,505

See accompanying notes to consolidated financial statements.

Donegal Group Inc.
Consolidated Statements of Income and Comprehensive Income

Year Ended December 31,	1998	1997	1996
Statements of Income			
Revenues			
Premiums earned	$172,507,090	$159,055,645	$145,712,891
Premiums ceded	56,338,098	51,753,477	41,185,853
Net premiums earned	116,168,992	107,302,168	104,527,038
Investment income, net of investment expenses	11,997,661	11,507,277	10,799,369
Installment payment fees	895,283	818,981	786,779
Lease income	753,408	643,183	541,010
Service fees	784,583	741,861	754,734
Net realized investment gains (losses)	(13,562)	314,136	172,734
Total revenues	30,586,365	121,327,606	117,581,664
Expenses			
Losses and loss expenses	110,448,552	99,408,492	98,615,417
Reinsurance recoveries	37,281,467	31,751,974	28,194,493
Net losses and loss expenses	73,167,085	67,656,518	70,420,924
Amortization of deferred policy acquisition costs	19,490,000	18,696,000	17,032,000
Other underwriting expenses	21,712,346	17,058,668	15,876,797
Policy dividends	1,635,300	1,319,384	1,609,369
Interest	1,292,992	910,237	375,311
Other	1,611,627	1,513,256	1,530,635
Total expenses	118,909,350	107,154,063	106,845,036
Income before income taxes	11,677,015	14,173,543	10,736,628
Income taxes	2,659,175	3,532,357	2,178,854
Net income	$ 9,017,840	$ 10,641,186	$ 8,557,774
Net income per common share			
Basic	$ 1.11	$ 1.33*	$ 1.10*
Diluted	$ 1.09	$ 1.32*	$ 1.09*
Statements of Comprehensive Income			
Net income	$ 9,017,840	$ 10,641,186	$ 8,557,774
Other comprehensive income (loss), net of tax			
Unrealized gains on securities:			
Unrealized holding gain (loss) arising during the period, net of income tax expense (benefit) of $151,999, $409,974 and ($186,364)	295,057	795,831	(361,766)
Reclassification adjustment for (gains) losses included in net income, net of income tax expense (benefit) of ($4,611), $106,806 and $58,730	8,951	(207,330)	(114,004)
Other comprehensive income (loss)	304,008	588,501	(475,770)
Comprehensive income	$ 9,321,848	$ 11,229,687	$ 8,082,004

* Restated for 4-for-3 stock split

See accompanying notes to consolidated financial statements.

Donegal Group Inc.
Consolidated Statements of Stockholders' Equity

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, January 1, 1996	0	$ 0	4,326,362	$4,326,362	$35,564,792	$ 898,696	$33,050,629	$(819,780)	$ 73,020,689
Issuance of common stock			214,207	214,207	2,297,923				2,512,130
Net income							8,557,774		8,557,774
Other comprehensive loss						(475,770)			(475,770)
Purchase of 43,739 shares of treasury stock								(71,976)	(71,976)
Cash dividends $.2475 per share*							(1,943,573)		(1,943,573)
Balance, December 31, 1996	0	$ 0	4,540,569	$4,540,569	$37,862,715	$ 422,916	$39,664,830	$(891,756)	$ 81,599,274
Issuance of common stock			61,523	61,523	1,069,402				1,130,925
Net income							10,641,186		10,641,186
Other comprehensive income						588,501			588,501
Cash dividends $.2925 per share*							(2,363,223)		(2,363,223)
Stock dividend			1,520,339	1,520,329			(1,520,329)		
Balance, December 31, 1997	0	$ 0	6,122,431	$6,122,431	$38,932,117	$1,011,417	$46,422,454	$(891,756)	$ 91,596,663
Issuance of common stock			141,542	141,542	2,339,205				2,480,747
Net income							9,017,840		9,017,840
Other comprehensive income						304,008			304,008
Cash dividends $.3375 per share*							(2,768,254)		(2,768,254)
Stock dividend			2,061,248	2,061,248			(2,061,248)		
Balance, December 31, 1998	0	$ 0	8,325,221	$8,325,221	$41,271,322	$1,315,425	$50,610,792	$(891,756)	$100,631,004

* Restated for 4-for-3 stock split

See accompanying notes to consolidated financial statements.

Donegal Group Inc.
Consolidated Statements of Cash Flow

Year Ended December 31,	1998	1997	1996
Cash Flows from Operating Activities:			
Net income	$ 9,017,840	$10,641,186	$ 8,557,774
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	520,675	390,857	256,694
Realized investment (gains) losses	13,562	(314,136)	(172,734)
Changes in Assets and Liabilities, net of acquisition:			
Losses and loss expenses	7,125,806	3,490,429	15,727,682
Unearned premiums	6,478,435	811,785	13,923,360
Accrued expenses	(542,693)	827,727	(300,425)
Premiums receivable	(1,253,529)	(169,213)	1,509,474
Deferred policy acquisition costs	(399,428)	(610,161)	(935,681)
Deferred income taxes	158,593	7,108	3,380
Reinsurance receivable	(6,182,621)	(78,023)	(12,649,518)
Accrued investment income	(186,170)	(112,644)	(124,330)
Amounts due from affiliate	(4,180,378)	(438,442)	1,514,009
Reinsurance balances payable	(127,931)	(11,926)	64,586
Prepaid reinsurance premiums	(3,819,226)	(508,964)	(9,281,222)
Current income taxes	(171,387)	(700,983)	1,353,718
Other, net	100,292	192,808	44,969
Net adjustments	(2,466,000)	2,776,222	10,933,962
Net cash provided by operating activities	6,551,840	13,417,408	19,491,736
Cash Flows from Investing Activities:			
Purchase of fixed maturities			
Held to maturity	(24,774,417)	(15,834,418)	(30,795,475)
Available for sale	(43,662,157)	(21,614,427)	(21,900,833)
Purchase of equity securities	(15,824,465)	(10,598,546)	(9,077,146)
Sale of fixed maturities			
Available for sale	2,207,500	--	7,247,675
Maturity of fixed maturities			
Held to maturity	24,815,155	11,909,421	11,996,190
Available for sale	16,106,644	18,860,222	17,634,933
Sale of equity securities	16,155,130	6,695,236	9,493,480
Acquisition of Delaware Atlantic	--	--	(202,243)
Acquisition of Southern Heritage	(18,028,072)	--	--
Purchase of property and equipment	(650,014)	(2,758,851)	(255,754)
Net sales (purchases) of short-term investments	15,099,631	(1,242,030)	(6,391,292)
Net cash used in investing activities	(28,555,065)	(14,583,393)	(22,250,465)
Cash Flows from Financing Activities:			
Issuance of common stock	2,480,747	1,130,925	2,512,130
Borrowings under line of credit, net	27,000,000	2,000,000	3,500,000
Cash dividends paid	(2,663,795)	(2,251,788)	(1,878,648)
Purchase of treasury stock	--	--	(71,976)
Net cash provided by financing activities	26,816,952	879,137	4,061,506
Net increase (decrease) in cash	4,813,727	(286,848)	1,302,777
Cash at beginning of year	3,413,315	3,700,163	2,397,386
Cash at end of year	$ 8,227,042	$ 3,413,315	$ 3,700,163

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1--Summary of Significant Accounting Policies

Organization and Business

Donegal Group Inc. (the "Company") was organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") and operates in the Mid-Atlantic and Southern states through its wholly-owned stock insurance companies, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Southern Heritage Insurance Company ("Southern Heritage"), Delaware Atlantic Insurance Company ("Delaware"), and Pioneer Insurance Company ("Pioneer") (collectively "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 65% of the pooled business. Southern cedes 50% of its business to the Mutual Company and Delaware cedes 70% of its Workers' Compensation business to the Mutual Company. At December 31, 1998, the Mutual Company held 60% of the outstanding common stock of the Company.

On June 25, 1998, the Company issued a 4-for-3 stock split in the form of a 33 1/3% stock dividend to stockholders of record as of June 10, 1998. Per share information prior to June 25, 1998, has been restated for this change.

In addition to the Company's Insurance Subsidiaries, it also owns all of the outstanding stock of Atlantic Insurance Services, Inc. ("AIS"), an insurance services organization currently providing inspection and policy auditing information on a fee-for-service basis to its affiliates and the insurance industry.

Basis of Consolidation

The consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles, include the accounts of Donegal Group Inc. and its wholly-owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The term "Company" as used herein refers 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.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the liabilities for losses and loss expenses. While management uses available information to provide for such liabilities, future changes to these liabilities may be necessary based on changes in trends in claim frequency and severity.

Investments

The Company classifies its debt and equity securities into the following categories:

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

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

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

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

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

Premiums and discounts for mortgage-backed debt securities are amortized using anticipated prepayments with significant changes in estimated prepayments accounted for under the prospective method.

Fair Values of Financial Instruments

The Company has used the following methods and assumptions in estimating its fair value disclosures:

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

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

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

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

Revenue Recognition

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

Policy Acquisition Costs

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

Property and Equipment

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

Losses and Loss Expenses

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

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

The Company has no material exposures to environmental liabilities.

Income Taxes

The Company and its subsidiaries currently file a consolidated federal income tax return.

The Company accounts 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 the Company's assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled.

Credit Risk

The Company provides property and liability coverages through its Insurance Subsidiaries' independent agency systems located throughout its operating area. The majority of this business is billed directly to the insured, although a portion of the Company's commercial business is billed through its agents, who are extended credit in the normal course of business.

The Company's Insurance Subsidiaries have reinsurance agreements in place with the Mutual Company and with a number of other authorized reinsurers with at least an A.M. Best rating of A- or an equivalent financial condition.

Reinsurance Accounting and Reporting

The Company relies upon reinsurance agreements to limit its maximum net loss from large single risks or risks in concentrated areas, and to increase its 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, the Company is exposed to the risk of continued liability for such losses. However, in an effort to reduce the risk of non-payment, the Company requires all of its reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition which, in the opinion of management, is equivalent to a company with at least an A- rating.

Stock-Based Compensation

Stock-based compensation plans are accounted for under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. As such, compensation expense would be recorded on the date of a stock option grant only if the current market price of the underlying stock exceeded the exercise price. Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," permits entities to recognize as expense, over the vesting period, the fair value of all stock-based awards on the date of the grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of APB Opinion No. 25 and provide pro-forma net income and earnings per share disclosures for employee stock option grants made as if the fair-value-based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro-forma disclosures under SFAS No. 123.

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.

Comprehensive Income

In 1998, the Company adopted SFAS No. 130, "Comprehensive Income," which established standards for the reporting and disclosure of comprehensive income and its components. Comprehensive income consists of net income and net unrealized investment gains or losses and is presented in the Consolidated Statements of Income and Comprehensive Income. The adoption of SFAS No. 130 had no impact on total shareholders' equity. Prior year financial statements have been reclassified to conform to these requirements.

2--Acquisitions of Businesses

In November 1998, the Company acquired all of the outstanding stock of Southern Heritage for a cash price of $18,361,279. Southern Heritage primarily writes personal automobile and homeowners policies in the Southeastern region of the country. This transaction was accounted for as a "purchase." The Company's financial statements include Southern Heritage as a consolidated subsidiary from November 1, 1998.

Assets in the amount of $56,568,710 were acquired, and liabilities in the amount of $38,330,912 were assumed in the purchase transaction. The purchase price exceeded the fair value of net assets acquired by $123,481, which is recognized as goodwill and is being amortized over ten years.

The following table reflects unaudited pro-forma combined results of operations of the Company and Southern Heritage on the basis that the acquisition had taken place at the beginning of each year. The pro-forma information is presented for information purposes only and is not indicative of the actual results that would have resulted if the acquisition had been made as of those dates. The pro-forma is not intended to be a projection of future results.

	1998	1997
Revenues	$161,307,562	$157,037,483
Net income	2,978,411	9,558,889
Earnings per common share		
Basic	.37	1.20
Diluted	.36	1.19

The above table includes interest expense and amortization of goodwill as if the acquisition occurred January 1, 1997.

In March 1997, the Company acquired all of the outstanding stock of Pioneer. This transaction was accounted for as if it were a "pooling of interest," and as such the Company's financial statements have been restated to include Pioneer as a consolidated subsidiary from January 1, 1993 to the present.

3--Transactions with Affiliates

The Company conducts business and has various agreements with the Mutual Company which are described below.

a. Reinsurance Pooling and Other Reinsurance Arrangements

Atlantic States cedes to the Mutual Company all of its insurance business and assumes from the Mutual Company 65% of the Mutual Company's total pooled insurance business, including that assumed from Atlantic States and substantially all of the business assumed and retained by the Mutual Company from Southern and Delaware. Atlantic States, Southern, Delaware and Pioneer each have a catastrophe reinsurance agreement with the Mutual Company which limits the maximum liability under any one catastrophic occurrence to $400,000, $300,000, $300,000 and $200,000, respectively, and $700,000 for a catastrophe involving more than one of the companies. The Mutual Company and Delaware have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $200,000 of losses in excess of $50,000 and a workers' compensation quota share agreement whereby Delaware cedes 70% of that business. The Mutual Company and Pioneer have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $200,000 of losses in excess of $50,000. The Mutual Company and Pioneer also have an aggregate excess of loss reinsurance agreement, entered into as part of the sale of Pioneer from the Mutual Company to Donegal Group Inc., in which the Mutual Company agrees to assume the adverse loss development of claims with dates of loss prior to

December 31, 1996, as developed through December 31, 1998, and to assume losses in excess of a 60% loss ratio through December 31, 1998. The Mutual Company and Southern have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $25,000 of losses in excess of $100,000 and a quota share agreement whereby Southern cedes 50% of its direct business less certain reinsurance to the Mutual Company. Southern, Delaware and Pioneer each have retrocessional reinsurance agreements effective July 1, 1996 with the Mutual Company under which they cede, and then assume back, 100% of their business net of other reinsurance.

The following amounts represent reinsurance transactions with the Mutual Company during 1998, 1997 and 1996:

Ceded reinsurance:	1998	1997	1996
Premiums written	$ 55,372,556	$ 47,946,847	$ 46,443,220
Premiums earned	$ 51,617,429	$ 47,488,716	$ 37,175,897
Losses and loss expenses	$ 32,791,739	$ 28,582,315	$ 25,838,753
Unearned premiums	$ 25,886,653	$ 22,131,526	$ 21,673,395
Liability for losses and loss expenses	$ 39,039,648	$ 35,295,994	$ 33,850,684

Assumed reinsurance:			
Premiums written	$114,667,549	$107,604,989	$108,982,894
Premiums earned	$111,333,956	$107,302,168	$ 95,910,375
Losses and loss expenses	$ 69,869,999	$ 68,104,859	$ 65,579,955
Unearned premiums	$ 51,819,000	$ 48,485,408	$ 48,182,587
Liability for losses and loss expenses	$ 85,766,514	$ 83,271,292	$ 80,203,642

Losses and loss expenses assumed from the Mutual Company for 1998, 1997 and 1996 are reported net of inter-company catastrophe recoveries which amounted to approximately $2.3 million, $0, and $9.5 million, respectively.

b. Expense Sharing

The Mutual Company provides facilities, management and other services to the Company, and the Company reimburses the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of the Company and the Mutual Company in the pooling arrangement, and management of both the Company and the Mutual Company consider this allocation to be reasonable. Charges for these services totalled $24,065,066, $21,739,911 and $19,365,166 for 1998, 1997 and 1996, respectively.

c. Lease Agreement

The Company leases office equipment and automobiles to the Mutual Company under a 10-year lease dated January 1, 1990. Future annual commitments under these leases are $723,000 for 1999 and 2000.

d. Inspection and Policy Auditing Services

AIS provides inspection and policy auditing services to the Mutual Company on a fee-for-service basis. Charges for these services totalled $559,845, $544,651, and $600,453 for 1998, 1997 and 1996, respectively.

4--Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 1998 and 1997, are as follows:

1998

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	$ 32,890,694	$ 484,622	$ 29,816	$ 33,345,500
Obligations of states and political subdivisions	66,941,133	3,489,849	10,044	70,420,938
Corporate securities	9,131,114	422,916	4,030	9,550,000

Mortgage-backed securities	18,220,847	96,014	--	18,316,861
Totals	$127,183,788	$4,493,401	$ 43,890	$131,633,299

1998

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	$ 54,975,813	$ 570,376	$106,689	$ 55,439,500
Obligations of states and political subdivisions	19,140,686	822,884	6,497	19,957,073
Corporate securities	10,642,598	150,045	5,324	10,787,319
Mortgage-backed securities	4,330,898	11,065	--	4,341,963
Equity securities	6,206,735	743,210	186,002	6,763,943
Totals	$ 95,296,730	$2,297,580	$304,512	$ 97,289,798

Held to Maturity (1997)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 41,450,057	$ 341,162	$ 99,819	$ 41,691,400
Obligations of states and political subdivisions	57,620,998	2,955,526	--	60,576,524
Corporate securities	7,249,829	327,364	6,693	7,570,500
Mortgage-backed securities	10,925,321	154,057	34,916	11,044,462
Totals	$117,246,205	$3,778,109	$141,428	$120,882,886

Available for Sale (1997)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 40,066,278	$159,106	$28,883	$ 40,196,501
Obligations of states and political subdivisions	12,109,254	652,996	--	12,762,250
Corporate securities	3,247,602	8,412	3,514	3,252,500
Mortgage-backed securities	1,499,208	20,792	--	1,520,000
Equity securities	6,551,020	821,409	97,867	7,274,562
Totals	$ 63,473,362	$1,662,715	$130,264	$ 65,005,813

The amortized cost and estimated fair value of fixed maturities at December 31, 1998, 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	$ 1,797,072	$ 1,813,000
Due after one year through five years	23,716,416	24,449,650
Due after five years through ten years	57,304,006	59,895,700
Due after ten years	26,145,447	27,158,088
Mortgage-backed securities	18,220,847	18,316,861
Total held to maturity	$127,183,788	$131,633,299
Available for sale		
Due in one year or less	$ 15,348,958	$ 15,441,000
Due after one year through five years	31,110,027	31,386,819
Due after five years through ten years	19,930,607	20,756,500
Due after ten years	18,369,505	18,599,573
Mortgage-backed securities	4,330,898	4,341,963
Total available for sale	$ 89,089,995	$ 90,525,855

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 1998 and 1997, amounted to $5,285,367 and $2,785,752, respectively.

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

	1998	1997	1996
Fixed maturities	$10,981,353	$10,703,397	$ 9,924,660
Equity securities	294,646	238,777	233,072
Short-term investments	1,385,500	1,141,834	1,091,855
Real estate	175,250	127,250	81,650
Investment income	12,836,749	12,211,258	11,331,237
Investment expenses	839,088	703,981	531,868
Net investment income	$11,997,661	$11,507,277	$10,799,369

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

	1998	1997	1996
Gross realized gains:			
Fixed maturities	$ 132,431	$ 84,196	$ 29,206
Equity securities	1,119,679	408,429	404,381
	1,252,110	492,625	433,587
Gross realized losses:			
Fixed maturities	5,180	694	689
Equity securities	1,260,492	177,795	260,164
	1,265,672	178,489	260,853
Net realized gains (losses)	$ (13,562)	$ 314,136	$ 172,734
Change in difference between fair value and cost of investments:			
Fixed maturities	$ 1,439,782	$ 2,248,484	$ (870,761)
Equity securities	(166,335)	355,544	54,461
	$ 1,273,447	$ 2,604,028	$ (816,300)

Income taxes on realized investment gains were ($4,611), $106,806 and $58,730 for 1998, 1997 and 1996, respectively. Deferred income taxes applicable to net unrealized investment gains included in shareholders' equity were $677,643 and $521,033 at December 31, 1998 and 1997, respectively. Donegal Group has not held or issued derivative financial instruments.

5--Deferred Policy Acquisition Costs

Changes in deferred policy acquisition costs are as follows:

	1998	1997	1996
Balance, January 1	$ 8,448,060	$ 7,837,899	$ 6,902,218
Acquisition of Southern Heritage	2,486,813	--	--
Acquisition costs deferred	19,889,428	19,306,161	17,967,681
Amortization charged to earnings	19,490,000	18,696,000	17,032,000
Balance, December 31	$11,334,301	$ 8,448,060	$ 7,837,899

6--Property and Equipment

Property and equipment at December 31, 1998 and 1997, consisted of the following:

	1998	1997	Estimated Useful Life
Cost--office equipment	$ 5,648,108	$ 3,653,494	5-15 years
automobiles	890,264	768,643	3 years
leasehold improvements	59,233	59,233	15-40 years
real estate	2,627,597	2,621,896	15-50 years
software	434,344	31,526	5 years
	9,659,546	7,134,792	
Accumulated depreciation	(3,739,126)	(2,196,268)	
	$ 5,920,420	$ 4,938,524	

Depreciation expense for 1998, 1997, and 1996 amounted to $559,710, $442,726 and $384,154, respectively.

7--Liability for Losses and Loss Expenses

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

	1998	1997	1996
Balance at January 1	$118,112,390	$114,621,961	$ 98,894,279
Less reinsurance recoverable	40,638,565	39,194,405	27,738,898
Net balance at January 1	77,473,825	75,427,556	71,155,381
Acquisition of Southern Heritage	14,967,242	--	--
New balance at beginning as adjusted	92,441,067	75,427,556	71,155,381
Incurred related to:			
Current year	75,463,085	69,040,518	73,211,924
Prior years	(2,296,000)	(1,384,000)	(2,791,000)
Total incurred	73,167,085	67,656,518	70,420,924
Paid related to:			
Current year	44,388,736	39,133,249	42,669,749
Prior years	27,356,000	26,477,000	23,479,000
Total paid	71,744,736	65,610,249	66,148,749
Net balance at December 31	93,863,416	77,473,825	75,427,556
Plus reinsurance recoverable	47,545,592	40,638,565	39,194,405
Balance at December 31	$141,409,008	$118,112,390	$114,621,961

The Company recognized a decrease in the liability for losses and loss expenses of prior years (favorable development) of $2.3 million, $1.4 million and $2.8 million in 1998, 1997 and 1996, respectively. These favorable developments are primarily attributable to lower-than-expected claim severity in the private passenger automobile liability, workers' compensation and commercial multiple peril lines of business.

8--Line of Credit

At December 31, 1998, pursuant to a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank of Connecticut, the Company had unsecured borrowings of $37.5 million. Such borrowings were made in connection with the acquisitions of Delaware, Pioneer, and Southern Heritage and various capital contributions to the subsidiaries. Per the terms of the credit agreement, the Company may borrow up to $40 million at interest rates equal to the bank's then current prime rate or the then current London interbank

Eurodollar bank rate plus 1.70%. At December 31, 1998, the interest rates were 7.75% on an outstanding prime rate balance of $22.5 million and 6.93375% on an outstanding Eurodollar rate balance of $15 million. In addition, the Company pays a rate of 3/10 of 1% per annum on the average daily unused portion of the bank's commitment. On each July 27, commencing July 27, 2001, the credit line will be reduced by $8 million. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

9--Unaffiliated Reinsurers

In addition to the primary reinsurance in place with the Mutual Company, the Insurance Subsidiaries have other reinsurance in place, principally with four unaffiliated reinsurers. The following amounts represent reinsurance transactions with unaffiliated reinsurers during 1998, 1997 and 1996:

Ceded reinsurance:	1998	1997	1996
Premiums written	$4,784,768	$4,315,594	$4,023,855
Premiums earned	$4,720,669	$4,264,761	$4,009,956
Losses and loss expenses	$4,489,728	$3,169,659	$2,355,740
Unearned premiums	$1,316,458	$ 750,757	$ 699,924
Liability for losses and loss expenses	$8,505,944	$5,342,571	$5,343,721

10--Income Taxes

The provision for income tax consists of the following:

	1998	1997	1996
Current	$2,500,582	$3,525,249	$2,175,474
Deferred	158,593	7,108	3,380
Federal tax provision	$2,659,175	$3,532,357	$2,178,854

The effective tax rate is different than the amount computed at the statutory federal rate of 34% for 1998, 1997 and 1996. The reason for such difference and the related tax effect are as follows:

	1998	1997	1996
Income before income taxes	$11,677,015	$14,173,543	$10,736,628
Computed "expected" taxes at 34%	$ 3,970,185	$ 4,819,005	$ 3,650,454
Tax-exempt interest	(1,180,773)	(1,130,311)	(1,076,764)
Dividends received deduction	(177,374)	(48,477)	(48,108)
Deduction for exercise of option	--	(1,700)	(399,904)
Other, net	47,137	(106,160)	53,176
Federal income tax provision	$ 2,659,175	$ 3,532,357	$ 2,178,854

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31 1998 and 1997, are as follows:

	1998	1997
Deferred tax assets:		
Unearned premium	$4,593,745	$3,297,008
Loss reserves	4,581,026	4,064,877
Net operating loss carryforward - Southern Heritage	3,429,107	--
Valuation allowance	(3,429,107)	--
Total	$9,174,771	$7,361,885
Deferred tax liabilities:		
Depreciation expense	$ 425,292	$ 341,945
Deferred policy acquisition costs	3,853,662	2,872,343
Salvage receivable	483,960	324,521
Unrealized gain	875,165	521,033
Total	$5,638,079	$4,059,842
Net deferred tax assets	$3,536,692	$3,302,043

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 related to the net operating loss carryforward of Southern Heritage should be established at December 31, 1998. Management has determined that it is not required to establish a valuation allowance for the other deferred tax assets of $9,174,771 and $7,361,885 at December 31, 1998 and 1997, since it is more likely than not that the deferred tax assets will be realized through reversals of existing temporary differences, future taxable income, carryback to taxable income in prior years, previously realized investment gain and the implementation of tax planning strategies.

As a result of the acquisition of Southern Heritage, net deferred tax asset of $549,851 were acquired.

At December 31, 1998 the Company has a net operating loss carryforward of $10,085,608 which is available to offset taxable income of Southern Heritage. Such net operating loss carryforward will expire beginning in 2009. Federal income tax laws limit the amount of net operating loss carryforward that the Company can use in any one year to $903,056.

11--Stock Compensation Plans

All share data presented in the following sections has been adjusted for the Company's 4-for-3 stock splits in July 1997 and June 1998.

Equity Incentive Plans

The Company has had an Equity Incentive Plan for key employees since 1986 and adopted a nearly identical new plan in 1996. Both plans provide for the granting of awards by the Board of Directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. The new plan was adopted in 1996 and amended in 1997 making a total of 1,233,141 shares available. The plans provide that stock options may become exercisable up to 10 years from date of grant, with an option price not less than fair market value on date of grant. The stock appreciation rights permit surrender of the option and receipt of the excess of current market price over option price in cash.

Information regarding activity in the Company's stock option plans is presented below:

	Number of Shares	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 1995	270,000	$ 8.57
Granted - 1996	--	--
Exercised - 1996	270,000	8.57
Forfeited - 1996	--	--
Outstanding at December 31, 1996	--	--
Granted - 1997	532,451	13.50
Exercised - 1997	2,963	13.50
Forfeited - 1997	13,632	13.50
Outstanding at December 31, 1997	515,856	13.50
Granted - 1998	497,333	18.00
Exercised - 1998	10,073	13.50
Forfeited - 1998	--	--
Outstanding at December 31, 1998	1,003,116	$15.73
Exercisable at:		
December 31, 1996	--	--
December 31, 1997	173,333	$13.50
December 31, 1998	502,965	$15.00

Shares available for future grants at December 31, 1998 are 216,248.

The following table summarizes information about fixed stock options at December 31, 1998:

	Exercise Prices	
	$13.50	$18.00
Options outstanding at December 31, 1998:		
Number of options	505,783	497,333
Weighted-average remaining contractual life	3.0 years	4.25 years
Options exercisable at December 31, 1998:		
Number of options	337,188	165,777

1996 Equity Incentive Plan For Directors
During 1996 the Company adopted an Equity Incentive Plan For Directors. The plan was amended in 1998, making 265,735 shares available for award. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 177 shares of restricted stock to each director on the first business day of January in each year, commencing January 2, 1997. As of December 31, 1998, the Company has 80,004 unexercised options under this plan. Additionally, 2,124, 2,124 and 0 shares of restricted stock were issued on January 2, 1998, 1997 and 1996, respectively.

Employee Stock Purchase Plans
During 1996 the Company adopted the 1996 Employee Stock Purchase Plan which replaced a similar plan that had been adopted effective January 1, 1988. The 1996 plan made 162,873 shares available for issuance.

The 1996 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 the Company's common stock on the last day before the first day of the enrollment period (June 1 and December 31). A summary of plan activity follows:

	Shares Issued	
	Price	Shares
January 1, 1996	$ 8.00859	10,009
July 1, 1996	$ 8.24766	10,804
January 1, 1997	$ 8.24766	11,689
July 1, 1997	$ 9.26367	11,357
January 1, 1998	$11.65430	8,901
July 1, 1998	$13.06875	9,179

On January 1, 1999, the Company issued an additional 10,227 shares at a price of $13.28125 per share under this plan.

Agency Stock Purchase Plan
On December 31, 1996, the Company adopted the Agency Stock Purchase Plan which made 514,102 shares available for issuance. The plan provides for agents of affiliated companies of Donegal Group Inc. 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 1998, 1997 and 1996, 35,003, 40,200 and 0 shares, respectively, were issued under this plan.

Pro-forma Disclosures
The weighted-average grant date fair value of options granted for the various plans during 1998, 1997 and 1996 was $4.48, $4.74 and $3.27, respectively.
The fair values above were calculated based upon risk-free interest rates of 5% for the Stock Purchase Plans and 6% for the Equity Incentive Plans, expected lives of 6 months for the Stock Purchase Plans and 5 years for the Equity Incentive Plans, expected volatility of 34% and an expected dividend yield of 2.40%.

The Company applies APB Opinion No. 25 in accounting for its stock-based compensation plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and certain of its stock purchase plans. Had the Company recognized stock compensation expense in accordance with SFAS No. 123, net income and earnings per share would have been reduced to the pro-forma amounts shown below:

	1998	1997	1996
Net income:			
As reported	$9,017,840	$10,641,186	$8,557,774
Pro-forma	8,362,764	10,263,965	8,530,468
Basic earnings per share:			
As reported	1.11	1.33	1.10
Pro-forma	1.03	1.28	1.09
Diluted earnings per share:			
As reported	1.09	1.32	1.09
Pro-forma	1.01	1.28	1.08

The calculation of pro-forma net income reflects only options granted in 1998, 1997 and 1996.

12--Statutory Net Income, Capital and Surplus and Dividend Restrictions

The following is selected information for the Insurance Subsidiaries as determined in accordance with accounting practices prescribed or permitted by insurance regulatory authorities.

	1998	1997	1996
Atlantic States			
Statutory capital and surplus	$ 62,672,151	$ 56,606,354	$ 47,914,415
Statutory unassigned surplus	$ 31,711,287	$ 25,645,490	$ 16,953,551
Statutory net income	$ 6,480,524	$ 7,349,284	$ 5,410,536
Southern			
Statutory capital and surplus	$ 6,388,316	$ 7,069,112	$ 6,608,944
Statutory unassigned surplus	$ 1,636,046	$ 2,316,842	$ 1,856,674
Statutory net income	$ 66,297	$ 703,727	$ 255,480
Delaware			
Statutory capital and surplus	$ 8,548,354	$ 7,657,691	$ 6,798,477
Statutory unassigned surplus	$ 3,348,354	$ 2,457,691	$ 1,598,477
Statutory net income	$ 1,085,807	$ 1,070,463	$ 1,120,952
Pioneer			
Statutory capital and surplus	$ 5,300,349	$ 5,377,492	$ 5,048,582
Statutory unassigned surplus	$ (1,699,651)	$ (1,622,508)	$ (1,951,418)
Statutory net income (loss)	$ 188,579	$ 542,799	$ (367,614)
Southern Heritage			
Statutory capital and surplus	$ 15,805,641	$ 16,532,876	$ 16,504,236
Statutory unassigned surplus	$(16,709,674)	$(12,482,439)	$(12,511,079)
Statutory net income (loss)	$ (3,937,548)	$ 151,135	$ (149,007)

The Company's principal source of cash for payment of dividends are dividends from its Insurance Subsidiaries which are required by law to maintain certain minimum capital and surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States, Southern, Delaware, Pioneer and Southern Heritage are also subject to Risk Based Capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 1998, all five companies' statutory capital and surplus were substantially above the RBC requirements. At December 31, 1998, amounts available for distribution as dividends to Donegal Group Inc. without prior approval of insurance regulatory authorities are $6,480,524 from Atlantic States, $638,832 from Southern, $1,085,807 from Delaware, $530,035 from Pioneer and $1,580,564 from Southern Heritage.

13--Reconciliation of Statutory Filings to Amounts Reported Herein

The Company's 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.

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

	Year Ended December 31,		
	1998	1997	1996
Statutory net income of insurance subsidiaries	$8,301,081	$ 9,666,273	$6,419,354
Increases (decreases):			
Deferred policy acquisition costs	399,428	610,161	935,681
Deferred federal income taxes	(158,593)	(7,108)	(3,380)
Salvage and subrogation recoverable	1,217,092	984,981	1,067,201

Consolidating eliminations and adjustments	(967,940)	(950,000)	--
Parent-only net income	178,249	291,831	155,894
Non-insurance subsidiary net income (loss)	48,523	45,048	(16,976)
Net income as reported herein	$9,017,840	$10,641,186	$8,557,774

	December 31, 1998	1997	1996
Statutory capital and surplus of insurance subsidiaries	$ 98,714,811	$ 76,710,649	$ 66,370,418
Increases (decreases):			
Deferred policy acquisition costs	11,334,301	8,448,060	7,837,899
Deferred federal income taxes	3,592,605	3,302,043	3,613,307
Salvage and subrogation recoverable	7,963,559	6,155,467	5,170,486
Statutory reserves	9,066,998	8,712,694	10,035,325
Non-admitted assets and other adjustments, net	1,178,102	394,432	355,540
Fixed maturities available for sale	2,038,604	808,908	271,795
Consolidating eliminations and adjustments	(36,383,362)	(16,121,711)	(16,121,711)
Parent-only equity	2,843,990	2,953,248	3,878,390
Non-insurance subsidiary equity	281,396	232,873	187,825
Stockholders' equity as reported herein	$100,631,004	$ 91,596,663	$ 81,599,274

14--Supplementary Information on Statement of Cash Flows

The following schedule reflects income taxes and interest paid during 1998, 1997 and 1996:

	1998	1997	1996
Income taxes	$2,671,969	$4,094,338	$825,136
Interest	$1,270,646	$ 904,385	$369,869

15--Earnings Per Share

The following information illustrates the computation of net income, outstanding shares and earnings per share on both a basic and diluted basis for the years ending December 31, 1998, 1997 and 1996:

	Net Income	Weighted-Average Shares Outstanding	Earnings Per Share
1998:			
Basic	$ 9,017,840	8,126,286	$1.11
Effect of stock options	--	123,404	(0.02)
Diluted	$ 9,017,840	8,249,690	$1.09
1997:			
Basic	$10,641,186	7,994,937	$1.33
Effect of stock options	--	41,274	(0.01)
Diluted	$10,641,186	8,036,211	$1.32
1996:			
Basic	$ 8,557,774	7,814,007	$1.10
Effect of stock options	--	53,818	(0.01)
Diluted	$ 8,557,774	7,867,825	$1.09

16--Condensed Financial Information of Parent Company

Condensed Balance Sheets
($ in thousands)

December 31,	1998	1997
Assets		
Investment in subsidiaries (equity method)	$134,441	$ 99,857
Cash	599	730
Property and equipment	2,276	2,139
Other	2,124	451
Total assets	$139,440	$103,177
Liabilities and Stockholders' Equity		
Liabilities		
Cash dividends declared to stockholders	$ 708	$ 604
Line of credit	37,500	10,500
Other	601	476
Total liabilities	38,809	11,580
Stockholders' equity		
Preferred stock, $1.00 par value, authorized 1,000,000 shares, none issued		
Commonstock, $1.00 par value, authorized 15,000,000 shares, issued 8,325,221 and 6,122,431 shares and outstanding 8,202,933 and 6,030,715 shares	8,325	6,123
Additional paid-in capital	41,271	38,932
Accumulated other comprehensive income	1,316	1,012
Retained earnings, including equity in undistributed net income of subsidiaries($64,922 and $56,082)	50,611	46,422
Treasury stock, at cost	(892)	(892)
Total stockholders' equity	100,631	91,597
Total liabilities and stockholders' equity	$139,440	$103,177

Condensed Statements of Income
($ in thousands)

Years Ended December 31,	1998	1997	1996*

Revenues			
Dividends-subsidiaries	$1,000	$ 950	$ 0
Other	776	658	572
Total revenues	1,776	1,608	572
Expenses			
Operating expenses	718	643	548
Interest	1,293	1,022	416
Total expenses	2,011	1,665	964
Income before income tax benefit and equity in undistributed net income of subsidiaries	(235)	(57)	(392)
Income tax benefit	(413)	(346)	(533)
Income before equity in undistributed net income of subsidiaries	178	289	141
Equity in undistributed net income of subsidiaries	8,840	10,352	8,417
Net income	$9,018	$10,641	$8,558

* Restated

Condensed Statements of Cash Flows
($ in thousands)

Years Ended December 31,	1998	1997	1996
Cash flows from operating activities:			
Net income	$ 9,018	$ 10,641	$ 8,558
Adjustments:			
Equity in undistributed net income of subsidiaries	(8,840)	(10,352)	(8,417)
Other	(921)	382	373
Net adjustments	(9,761)	(9,970)	(8,044)
Net cash provided	(743)	671	514
Cash flows from investing activities:			
Net purchase of property and equipment	(564)	(1,251)	(203)
Capital contribution to subsidiaries	(2,000)	--	(5,000)
Acquisition of Delaware Atlantic	--	--	(202)
Acquisition of Southern Heritage	(18,361)	--	--
Other	(5,280)	4	1,110
Net cash used	(26,205)	(1,247)	(4,295)
Cash flows from financing activities:			
Cash dividends paid	(2,664)	(2,252)	(1,879)
Issuance of common stock	2,481	1,131	2,512
Purchase of treasury stock	--	--	(72)
Line of credit, net	27,000	2,000	3,500
Net cash provided	26,817	879	4,061
Net change in cash	(131)	303	280
Cash at beginning of year	730	427	147
Cash at ending of year	$ 599	$ 730	$ 427

17--Segment Information

In 1998, Donegal Group Inc. adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" which establishes standards for reporting information about operating segments. As an underwriter of property and casualty insurance, the Company has three reportable segments which consist of the investment function, the personal lines of insurance and the commercial lines of insurance. Using independent agents, the Company markets personal lines of insurance to individuals and commercial lines of insurance to small and medium-sized businesses.

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

Assets are not allocated to the personal and commercial lines and are reviewed in total by management for purposes of decision making. Donegal Group Inc. operates 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:

	1998	1997	1996
	($ in thousands)		
Revenues:			
Premiums earned:			
Commercial lines	$ 44,493	$ 45,702	$ 46,171
Personal lines	71,676	61,600	58,356
Total premiums earned	116,169	107,302	104,527
Net investment income	11,998	11,507	10,799
Realized investment gains (losses)	(14)	314	173
Other	2,433	2,205	2,083
Total revenues	$130,586	$121,328	$117,582
Income before income taxes:			
Underwriting income (loss):			
Commercial lines	$ 3,688	$ 3,497	$ 6,121
Personal lines	(5,327)	(2,734)	(8,699)
SAP underwriting gain (loss)	(1,639)	763	(2,578)
GAAP adjustments	1,803	1,809	2,166
GAAP underwriting gain (loss)	164	2,572	(412)
Net investment income	11,998	11,507	10,799
Realized investment gains (losses)	(14)	314	173
Other	(471)	(219)	177
Income before income taxes	$ 11,677	$ 14,174	$ 10,737

18--Interim Financial Data (unaudited)

	1998			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$27,204,544	$27,578,257	$28,064,764	$33,321,427
Total revenues	30,896,144	31,023,026	31,654,736	37,012,459
Loss and loss adjusting expenses	15,801,905	19,225,138	20,434,534	17,705,508
Net income	3,316,653	1,892,892	44,414	3,763,881
Net income per common share				
Basic	$.41	$.22	$.01	$.46
Diluted	.40	.22	.01	.46

	1997			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$26,404,333	$26,823,505	$27,260,693	$26,813,637
Total revenues	29,823,371	30,253,860	30,909,916	30,340,459
Loss and loss adjusting expenses	16,912,543	17,329,403	17,111,129	16,303,443
Net income	2,562,433	2,400,597	2,911,728	2,766,428
Net income per common share				
Basic	$.32	$.30	$.37	$.35
Diluted	.32	.30	.36	.34

Donegal Group Inc.
Independent Auditors' Report

The Stockholders and Board of Directors
Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. as of December 31, 1998 and 1997, 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, 1998. 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 generally accepted auditing standards. 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. as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1998 in conformity with generally accepted accounting principles.

KPMG LLP

Philadelphia, Pennsylvania
March 2, 1999

Market Information

Donegal Group's common stock is traded on NASDAQ under the symbol "DGIC." During 1997 and 1998, the stock price ranged as follows (information prior to June 25, 1998 restated for 4-for-3 stock split on that date):

Quarter	High	Low	Cash Dividend Declared Per Share
1997			
1st*	14.203	11.25	--
2nd*	14.25	12.75	.0675
3rd*	15.75	13.6875	.075
4th*	16.6875	15.1875	.15
1998			
1st*	17.625	15.188	--
2nd*	22.781	16.875	.0825
3rd	19.875	14.250	.085
4th	15.750	12.625	.17

* Restated

EXHIBIT 21

SUBSIDIARIES OF REGISTRANT

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

Name	State of Formation
Atlantic States Insurance Company	Pennsylvania
Southern Insurance Company of Virginia	Virginia
Pioneer Insurance Company	Ohio
Delaware Atlantic Insurance Company	Delaware
Southern Heritage Insurance Company	Georgia

Registrant owns 100% of the outstanding stock of the following business corporation:

Name	State of Formation
Atlantic Inspection Services, Inc.	Maryland

EXHIBIT 23

Independent Auditors' Consent and Report on Schedules

The Board of Directors
Donegal Group Inc.:

The audits referred to in our report dated March 2, 1999 include the related financial statement schedules as of December 31, 1998, and for each of the years in the three-year period ended December 31, 1998, included in the annual report on Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We consent to incorporation by reference in the registration statements (Nos. 333-1287, 333-06681, 33-26693 and 33-61095) on Form S-8 and registration statement (No. 333-36585) on Form S-3 of Donegal Group Inc. of our report dated March 2, 1999, relating to the consolidated balance sheets of Donegal Group Inc. as of December 31, 1998 and 1997, and the related consolidated statements of income and comprehensive income, stockholders' equity and cash flows and related financial statement schedules for each of the years in the three-year period ended December 31, 1998, which report appears in the December 31, 1998 annual report on Form 10-K of Donegal Group Inc.

KPMG LLP

Philadelphia, Pennsylvania
March 26, 1999

YEAR
DEC-31-1998
JAN-01-1998
DEC-31-1998
90,525,855
127,183,788
131,633,299
6,763,943
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254,995,473
8,227,042
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11,334,301
385,231,506
141,409,008
94,722,785
0
0
37,500,000
0
0
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385,231,506
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11,997,661
(13,562)
2,433,274
73,167,085
19,490,000
21,712,346
11,677,015
2,659,175
9,017,840
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0
0
9,017,840
1.11
1.09
92,441,067
75,463,085
(2,296,000)
44,388,736
27,356,000
93,863,416
(2,296,000)