# UNITED STATES SECURITIES AND EXCHANGE COMMISSION
**Washington, D.C. 20549**

# FORM 10-K

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

**For the fiscal year ended December 31, 2005**

**OR**

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

**For the transition period from ____________________ to ____________________**

**Commission file number 0-15341**

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

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

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

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

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

Class A Common Stock, $.01 par value

Class B Common Stock, $.01 par value

(Title of class)

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

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

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

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

On June 30, 2005, the aggregate market value (based on the closing sales prices on that date) of the voting stock held by non-affiliates of the registrant was $186,016,853.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Required ☑. Not required o.

Indicate by check mark whether the registrant qualifies as a well-known seasoned issuer. Qualifies o. Does not qualify ☑.

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 14,283,996 shares of Class A Common Stock and 4,182,684 shares of Class B Common Stock were outstanding on February 27, 2006.

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DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the registrant's annual report to stockholders for the fiscal year ended December 31, 2005 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 20, 2006 are incorporated by reference into Part III of this report.

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DONEGAL GROUP INC.
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2005 Annual Report to Stockholders
Subsidiaries of Registrant
Report and Consent of Independent Registered Public Accounting Firm
Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer
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PART I

## Item 1. Business.

(a) General Development of Business.

We are a property and casualty insurance holding company whose insurance subsidiaries offer personal and commercial lines of insurance to businesses and individuals in 18 Mid-Atlantic, Midwestern and Southeastern states. We provide our policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline. At December 31, 2005, we had total assets of $781.4 million and stockholders' equity of $277.9 million. Our net income was $36.9 million for the year ended December 31, 2005 compared to $31.6 million for the year ended December 31, 2004.

Donegal Mutual Insurance Company ("Donegal Mutual") owns approximately 42% of our Class A common stock and approximately 68% of our Class B common stock. The operations of our insurance subsidiaries are interrelated with the operations of Donegal Mutual and, while maintaining the separate corporate existence of each company, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, we share the same business philosophy, management, employees and facilities as Donegal Mutual and offer the same types of insurance products.

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

- a purchase of the stock of an existing stock insurance company; or
- a two-step acquisition of an existing mutual insurance company as follows:
  - First, Donegal Mutual purchases a surplus note from a mutual insurance company and/or Donegal Mutual enters into a management agreement with the mutual insurance company and, in either circumstance, our designees are appointed as a majority of the mutual insurance company's board of directors.
  - Second, the mutual insurance company is converted into a stock insurance company. At the effective date of the conversion, we purchase the surplus note from Donegal Mutual and acquire the stock of the stock insurance company resulting from the conversion of the mutual company after its book of business has been reunderwritten to our satisfaction.

We believe that our ability to make direct acquisitions or to structure acquisitions through Donegal Mutual surplus note and/or management agreement transactions provides us with flexibility that is a competitive advantage in seeking acquisitions. We also believe we have demonstrated our ability to acquire control of a troubled insurance company, reunderwrite its book of business, reduce its cost structure and return it to profitability. When Donegal Mutual makes a surplus note investment in another company and/or enters into a management agreement with it, the financial results of that company are not consolidated with our financial results or those of Donegal Mutual, and neither we nor Donegal Mutual are responsible for the insurance obligations of that company.

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

We did not complete any acquisitions in 2005.

On September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, "Shelby"), part of Vesta Insurance Group, Inc. The agreement grants those members the right, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby's personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby's plans of withdrawal from those three states. As part of the agreement, the Donegal Insurance Group will pay specified amounts to Shelby based on the direct premiums written by the Donegal Insurance Group on the renewal and replacement policies it issues. Renewal and replacement policies will be offered for policies issued on or after January 1, 2006. Thus, the agreement had no impact on our 2005 operating results.

(b) Financial Information About Industry Segments.

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

(c) Narrative Description of Business.

*Who We Are*

We are a property and casualty insurance holding company whose insurance subsidiaries offer personal and commercial lines of insurance to small businesses and individuals in 18 Mid-Atlantic, Midwestern and Southeastern states. We provide our

policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline.

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

*Strategy*

Our annual premiums earned have increased from $151.6 million in 2000 to $294.5 million in 2005, a compound annual growth rate of 14.2%. Over the same time period, our combined ratio has consistently been more favorable than that of the property and casualty insurance industry as a whole. We seek to grow our business and enhance our profitability by:

- *Achieving underwriting profitability.*

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

Our combined ratio and that of our industry for the years 2000 through 2005 are shown in the following table:

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|
| Donegal GAAP combined ratio | 101.8% | 103.8% | 99.6% | 95.0% | 93.1% | 89.5% |
| Industry SAP combined ratio[1] | 110.4 | 115.9 | 107.4 | 100.1 | 97.6 | 102.0 |

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

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

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

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

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

- Location in regions where we are currently conducting business or offer an attractive opportunity to conduct profitable business;
- A mix of business similar to our business;
- Targeted premium volume between $20.0 million and $100.0 million; and
- Transaction terms that are fair and reasonable to us.

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

when considering acquisitions, including product underwriting, expenses, the cost of reinsurance and technology.

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

We maintain stringent expense controls under direct supervision by our senior management. We consolidate many processing and administrative activities at our home office to realize operating synergies and better control expenses. We utilize technology to automate much of our underwriting to facilitate agency and policyholder communications on an efficient and cost-effective basis. In 2002, we completed a reorganization begun in 2001 that streamlined our operations and allowed us to operate more efficiently. As a result of our focus on expense control, we have reduced our expense ratio from 36.6% for 1999 to 32.1% for 2005, notwithstanding performance-based compensation paid to agents in 2005 of $11.3 million because of our premium growth and underwriting profitability compared to $4.0 million in 1999. We have also increased our annual premium per employee, a measure of efficiency that we use to evaluate our operations, from approximately $470,000 in 1998 to approximately $718,000 in 2005.

We strive to possess and utilize technology comparable to that of our largest competitors. “Ease of doing business” has become an increasingly important component of a carrier’s value to an independent agency. We developed and implemented a fully automated personal lines underwriting and policy issuance system, which we refer to as our “WritePro” system. We implemented the system in Pennsylvania, Virginia, Georgia and Ohio during 2005. A web-based user interface affords our agents convenient access to the system, and this technological enhancement substantially improves the ease of data entry and facilitates the quoting and issuance of policies for our agents. Due to the positive response to our WritePro system, we also developed a commercial business counterpart, which we have named “WriteBiz.” WriteBiz is an automated underwriting system that provides our agents with a similar web-based interface to quote and issue commercial automobile, workers’ compensation, businessowners and tradesman policies automatically. WriteBiz utilizes the same rating engine as our internal underwriting system and incorporates our eligibility and underwriting guidelines. As a result, applications generated by our agents can be quickly transitioned to policies without further re-entry of information, and policy information is then fully downloaded to our agent’s policy management systems through our existing download capabilities.

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

We believe that excellent policyholder service is important to attracting new policyholders and retaining existing policyholders. We work closely with our agency force to provide a consistently responsive level of claims service, underwriting and customer

support. We seek to respond expeditiously and effectively to address customer and agent inquiries, including working to:

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

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

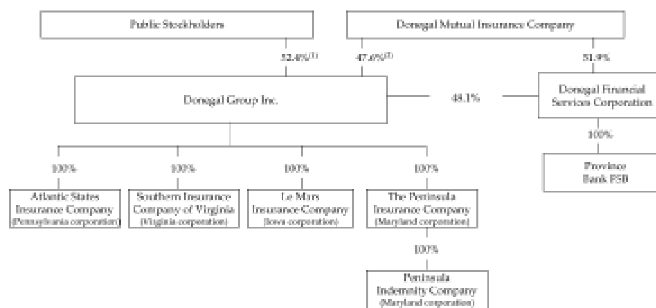
- *Maintaining premium rate adequacy to enhance our underwriting results, while maintaining our existing book of business and preserving our ability to write new business.*

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

*Our Organizational Structure*

We conduct most of our operations through our five insurance subsidiaries: Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Le Mars Insurance Company ("Le Mars") and Peninsula Insurance Group ("Peninsula"), which includes The Peninsula Insurance Company and its wholly owned subsidiary, Peninsula Indemnity Company. We also own 48.1% of Donegal Financial Services Corporation ("DFSC"), a registered savings and loan holding company that owns Province Bank, a federal savings bank that began operations in 2000. Donegal Mutual owns the remaining 51.9% of DFSC. While not material to our operations, we believe Province Bank, with total assets of $76.6 million at December 31, 2005, will complement our product

offerings. The following chart depicts our organizational structure, including our principal subsidiaries:




(1) Because of the different relative voting power of our Class A common stock and our Class B common stock, our public stockholders hold approximately 39.4% of the aggregate voting power.

(2) Because of the different relative voting power of our Class A common stock and our Class B common stock, Donegal Mutual holds approximately 60.6% of the aggregate voting power.

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

Since 1986, we have effected three public offerings, a major purpose of which was to provide capital for Atlantic States and our other insurance subsidiaries and to fund acquisitions. As Atlantic States received additional capital, its underwriting capacity significantly increased. Thus, as originally planned in the mid-1980's, Atlantic States had the capital necessary to support the growth of its direct business and increases in the amount and

percentage of business it assumes from the pool. As a result, the participation of Atlantic States in the inter-company pool has increased periodically from its initial 30% participation in 1986 to its current 70% participation, and the size of the pool has steadily increased. The corresponding benefit to Donegal Mutual has been the substantial increase in Donegal Mutual's surplus and the significant growth of its overall business.

Our insurance operations are interrelated with the insurance operations of Donegal Mutual, and, while maintaining the separate corporate existence of each company, Donegal Mutual and we conduct our insurance business together with our other insurance subsidiaries as the Donegal Insurance Group. As such, Donegal Mutual and we share the same business philosophy, management, employees and facilities and offer the same types of insurance products. We do not anticipate any changes in the pooling agreement with Donegal Mutual, including changes in Atlantic States' pool participation level, in the foreseeable future.

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

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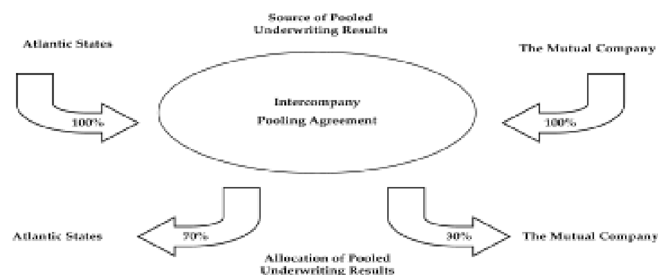
The following chart depicts our underwriting pool:




Donegal Mutual provides facilities, personnel and other services to us, and the related expenses are allocated between Atlantic States and Donegal Mutual in relation to their relative participation in the pooling agreement. Southern and Le Mars reimburse Donegal Mutual for their personnel costs, and Southern bears its proportionate share of information services costs based on its percentage of total written premiums of the Donegal Insurance Group. Expenses allocated to us under such agreements were $47.0 million in 2005.

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

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

- Facilitating our stable management, consistent underwriting discipline, external growth and long-term profitability.
- Creating operational and expense synergies given the combined resources and operating efficiencies of Donegal Mutual and us.
- Enhancing our ability to affiliate with and eventually acquire other mutual insurance companies.

- Producing a more uniform and stable underwriting result from year to year than we could achieve on our own.
- Giving Atlantic States the benefit of the underwriting capacity of the entire pool, rather than being limited by the amount of its own capital and surplus.

*Acquisitions*

The following table highlights our acquisition history since 1988:

| Insurance Company Acquired | State | Year Acquired by Us | Method of Acquisition |
|---|---|---|---|
| Southern Mutual Insurance Company | Virginia | 1988 | Surplus note investment by Donegal Mutual in 1984; demutualization in 1988; acquisition of stock by us in 1988. |
| Delaware Mutual Insurance Company(1) | Delaware | 1995 | Surplus note investment by Donegal Mutual in 1993; demutualization in 1994; acquisition of stock by us in 1995. |
| Pioneer Mutual Insurance Company(1) | Ohio | 1997 | Surplus note investment by Donegal Mutual in 1992; demutualization in 1993; acquisition of stock by us in 1997. |
| Southern Heritage Insurance Company(1) | Georgia | 1998 | Stock purchase in 1998. |
| Pioneer Mutual Insurance Company(1) | New York | 2001 | Surplus note investment by Donegal Mutual in 1995; demutualization in 1998; acquisition of stock by us in 2001. |
| Le Mars Insurance Company | Iowa | 2004 | Surplus note investment by Donegal Mutual in 2002; demutualization as of January 1, 2004; acquisition of stock by us |

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| Insurance Company Acquired | State | Year Acquired by Us | Method of Acquisition |
|---|---|---|---|
| | | | as of January 1, 2004. |
| Peninsula Insurance Group | Maryland | 2004 | Stock purchase by us as of January 1, 2004. |

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

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

*Distribution*

Our insurance products are marketed primarily in the Mid-Atlantic, Midwest and Southeast regions through approximately 2,000 independent insurance agencies. At December 31, 2005, the Donegal Insurance Group was actively writing business in 18 states (Alabama, Delaware, Georgia, Iowa, Louisiana, Maryland, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia and West Virginia). We believe our relationships with our independent agents are valuable in identifying, obtaining and retaining profitable business. We maintain a stringent agency selection procedure that emphasizes appointing agencies with proven marketing strategies for the development of profitable business and we appoint only agencies with a strong underwriting and growth track record. We also regularly evaluate our agencies based on their profitability and performance in relation to our objectives. We seek to be among the top three insurers within each of our agencies for the lines of business we write.

The following table sets forth the percentage of our share of 2005 direct premiums written in each of the states where we conducted business in 2005:

| | |
|---|---|
| Pennsylvania | 45.2% |
| Maryland | 14.0 |
| Virginia | 12.1 |
| Georgia | 5.7 |
| Delaware | 5.7 |
| Ohio | 4.0 |
| Iowa | 3.1 |
| North Carolina | 2.3 |

| | |
|---|---|
| Tennessee | 1.4 |
| Oklahoma | 1.3 |
| Nebraska | 1.3 |
| South Dakota | 1.3 |
| New York | 0.9 |
| Other | 1.7 |
| Total 1 | 100.0% |

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

*Products*

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

*Personal*

- Private passenger automobile – policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and protection against loss from damage to automobiles owned by the insured.
- Homeowners – policies that provide coverage for damage to residences and their contents from a broad range of perils, including, fire, lightning, windstorm and theft. These policies also cover liability of the insured arising from injury to other persons or their property while on the insured’s property and under other specified conditions.

*Commercial*

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

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

| (dollars in thousands) | Year Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2003 | | 2004 | | 2005 | |
| | Amount | % | Amount | % | Amount | % |
| Net Premiums Written: | | | | | | |
| Personal lines: | | | | | | |
| Automobile | $ 86,644 | 41.9% | $ 118,734 | 41.9% | $ 122,059 | 40.4% |
| Homeowners | 36,989 | 17.9 | 47,540 | 16.8 | 52,149 | 17.2 |
| Other | 6,753 | 3.2 | 9,882 | 3.5 | 10,620 | 3.5 |
| Total personal lines | 130,386 | 63.0 | 176,156 | 62.2 | 184,828 | 61.1 |
| Commercial lines: | | | | | | |
| Automobile | 18,655 | 9.0 | 32,679 | 11.5 | 34,641 | 11.4 |
| Workers' compensation | 25,627 | 12.4 | 29,228 | 10.3 | 33,154 | 11.0 |
| Commercial multi-peril | 30,199 | 14.6 | 42,253 | 14.9 | 46,406 | 15.3 |
| Other | 2,114 | 1.0 | 2,966 | 1.1 | 3,515 | 1.2 |
| Total commercial lines | 76,595 | 37.0 | 107,126 | 37.8 | 117,716 | 38.9 |
| Total business | $ 206,981 | 100.0% | $ 283,282 | 100.0% | $ 302,544 | 100.0% |

*Underwriting*

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

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

- assess and select quality standard and preferred risks;

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

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

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

*Claims*

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

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

staffed by former law enforcement officers that attempts to identify and prevent fraud and abuse and to control questionable claims.

Our claims department management develops and implements policies and procedures for the establishment of adequate claim reserves. Our reserves for incurred but not reported claims are reviewed by our actuary. The management and staff of our claims department resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters. Our litigation and personal injury sections manage all claims litigation, and branch office claims above certain thresholds require home office review and settlement authorization. Claims adjusters are given reserving and settlement authority based upon their experience and demonstrated abilities. Larger or more complicated claims require consultation and approval of senior department management.

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

*Liabilities for Losses and Loss Expenses*

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

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

Reserve estimates can change over time because of unexpected changes in assumptions related to our external environment and, to a lesser extent, assumptions as to our internal operations. Assumptions related to our external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions, stability in economic conditions and the rate of loss cost inflation. For example, we have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business. To the extent we determine that underlying factors impacting our assumptions have changed, we attempt to make appropriate adjustments for such changes in our reserves. Accordingly, our ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at December 31, 2005. For every 1% change in our estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately $1.7 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that our ultimate liability will not exceed our loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to our estimated future liabilities cannot be predicted, since the historical conditions and events that serve as a basis for our estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, we have found it necessary in the past to increase our estimated future liabilities for losses and loss expenses in certain periods, and in other periods our estimates have exceeded our actual liabilities. Changes in our estimate of the liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. We recognized a decrease in our liability for losses and loss expenses of prior years of $9.4 million, $7.2 million and $450,110 in 2005, 2004 and 2003, respectively. Generally, we experienced improving loss development trends in 2005 and 2004, which were reflected in favorable settlements of open claims. We made no significant changes in our reserving philosophy, key reserving assumptions or claims management, and there have been no significant offsetting changes in estimates that increased or decreased the loss and loss expense reserves in these periods. The 2005 development was primarily recognized in the private passenger automobile liability, workers' compensation and commercial multi-peril lines of business and was consistently favorable for settlements of claims occurring in each of the previous five accident years. The majority of the 2005 development was related to decreases in the liability for losses and loss expenses of prior years for Atlantic States. Included in the 2004 development are decreases in

the liability for losses and loss expenses of prior years for Le Mars and Peninsula of $3.6 million and $1.4 million, respectively, largely due to favorable settlement of open claims in the private passenger automobile liability line of business.

Excluding the impact of isolated catastrophic weather events, we have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to our premium base in recent years across most of our lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic conditions extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims. Further adjustments to our estimates could be required in the future. However, on the basis of our internal procedures, including review by our actuaries, which analyze, among other things, our prior assumptions, our experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that we have made adequate provision for our liability for losses and loss expenses.

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

Differences between liabilities reported in our financial statements prepared on the basis of GAAP and our insurance subsidiaries' financial statements prepared on a statutory accounting basis ("SAP") result from anticipating salvage and subrogation recoveries for GAAP but not for SAP. These differences amounted to $7.2 million, $8.1 million and $8.3 million at December 31, 2003, 2004 and 2005, respectively.

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

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| (in thousands) | Year Ended December 31, 2003 | 2004 | 2005 |
|---|---|---|---|
| Gross liability for unpaid losses and loss expenses at beginning of year | $210,692 | $217,914 | $267,190 |
| Less reinsurance recoverable | 79,584 | 79,018 | 95,759 |
| Net liability for unpaid losses and loss expenses at beginning of year | 131,108 | 138,896 | 171,431 |
| Acquisitions of Le Mars and Peninsula | — | 28,843 | — |
| Beginning balance as adjusted | 131,108 | 167,739 | 171,431 |
| Provision for net losses and loss expenses for claims incurred in the current year | 126,693 | 171,385 | 176,924 |
| Change in provision for estimated net losses and loss expenses for claims incurred in prior years | (450) | (7,244) | (9,382) |
| Total incurred | 126,243 | 164,141 | 167,542 |
| Net losses and loss payments for claims incurred during: | | | |
| The current year | 72,187 | 96,041 | 98,735 |
| Prior years | 46,268 | 64,409 | 67,229 |
| Total paid | 118,455 | 160,450 | 165,964 |
| Net liability for unpaid losses and loss expenses at end of year | 138,896 | 171,431 | 173,009 |
| Plus reinsurance recoverable | 79,018 | 95,759 | 92,721 |
| Gross liability for unpaid losses and loss expenses at end of year | $217,914 | $267,190 | $265,730 |

The following table sets forth the development of our liability for net unpaid losses and loss expenses from 1995 to 2005, with supplemental loss data for 2004 and 2005. Loss data in the table includes business we are allocated from Donegal Mutual as part of the pooling agreement.

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

The "Net liability reestimated as of" portion of the table shows the reestimated amount of the previously recorded liability based on experience for each succeeding year. The estimate is increased or decreased as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 1998 liability has developed a redundancy after seven years, in that reestimated net losses and loss expenses are expected to be $3.6 million less than the estimated liability initially established in 1998 of $96.0 million.

The “Cumulative (excess) deficiency” shows the cumulative excess or deficiency at December 31, 2005 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 1998 column indicates that as of December 31, 2005 payments equal to $87.6 million of the currently reestimated ultimate liability for net losses and loss expenses of $92.4 million had been made.

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

| (in thousands) | Year Ended December 31, 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Net liability at end of year for unpaid losses and loss expenses | $ 75,372 | $ 78,889 | $ 80,256 | $ 96,015 | $ 99,234 | $ 102,709 | $ 114,544 | $ 131,108 | $ 138,896 | $ 171,431 | $ 173,009 |
| Net liability reestimated as of: | | | | | | | | | | | |
| One year later | 72,380 | 77,400 | 77,459 | 95,556 | 100,076 | 110,744 | 121,378 | 130,658 | 136,434 | 162,049 | |
| Two years later | 70,451 | 73,438 | 76,613 | 95,315 | 103,943 | 112,140 | 120,548 | 128,562 | 130,030 | | |
| Three years later | 66,936 | 71,816 | 74,851 | 94,830 | 104,073 | 110,673 | 118,263 | 124,707 | | | |
| Four years later | 64,356 | 69,378 | 73,456 | 94,354 | 101,880 | 108,766 | 114,885 | | | | |
| Five years later | 63,095 | 69,485 | 73,103 | 93,258 | 100,715 | 107,561 | | | | | |
| Six years later | 62,323 | 69,949 | 72,706 | 92,818 | 100,479 | | | | | | |
| Seven years later | 62,534 | 69,415 | 72,319 | 92,400 | | | | | | | |
| Eight years later | 62,067 | 69,279 | 72,421 | | | | | | | | |
| Nine years later | 61,916 | 69,310 | | | | | | | | | |
| Ten years later | 62,003 | | | | | | | | | | |
| Cumulative (excess) deficiency | $ (13,369) | $ (9,579) | $ (7,835) | $ (3,615) | $ 1,245 | $ 4,852 | $ 341 | $ (6,401) | $ (8,866) | $ (9,382) | |
| Cumulative amount of liability paid through: | | | | | | | | | | | |
| One year later | $ 24,485 | $ 27,229 | $ 27,803 | $ 37,427 | $ 39,060 | $ 43,053 | $ 45,048 | $ 46,268 | $ 51,965 | $ 67,229 | |
| Two years later | 37,981 | 41,532 | 46,954 | 57,347 | 60,622 | 67,689 | 70,077 | 74,693 | 81,183 | | |
| Three years later | 47,027 | 53,555 | 58,883 | 69,973 | 76,811 | 82,268 | 87,198 | 93,288 | | | |
| Four years later | 53,276 | 59,995 | 65,898 | 78,757 | 85,453 | 92,127 | 97,450 | | | | |
| Five years later | 56,869 | 63,048 | 70,642 | 83,038 | 91,337 | 98,007 | | | | | |
| Six years later | 58,286 | 65,595 | 72,801 | 85,935 | 94,420 | | | | | | |
| Seven years later | 59,160 | 66,976 | 74,444 | 87,600 | | | | | | | |
| Eight years later | 59,802 | 67,974 | 75,372 | | | | | | | | |
| Nine years later | 59,797 | 68,596 | | | | | | | | | |
| Ten years later | 60,120 | | | | | | | | | | |

| | Year Ended December 31, 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | (in thousands) | | | | |
| Gross liability at end of year | $ 115,801 | $ 136,727 | $ 144,180 | $ 156,476 | $ 179,840 | $ 210,692 | $ 217,914 | $ 267,190 | $ 265,730 |
| Reinsurance recoverable | 35,545 | 40,712 | 44,946 | 53,767 | 65,296 | 79,584 | 79,018 | 95,759 | 92,721 |
| Net liability at end of year | 80,256 | 96,015 | 99,234 | 102,709 | 114,544 | 131,108 | 138,896 | 171,431 | 173,009 |
| Gross reestimated liability – latest | 106,447 | 130,885 | 157,791 | 174,384 | 193,629 | 215,165 | 222,390 | 257,332 | |
| Reestimated recoverable – latest | 34,026 | 38,485 | 57,312 | 66,823 | 78,744 | 90,458 | 92,360 | 95,283 | |
| Net reestimated liability – latest | 72,421 | 92,400 | 100,479 | 107,561 | 114,885 | 124,707 | 130,030 | 162,049 | |
| Gross cumulative deficiency (excess) | (9,354) | (5,842) | 13,611 | 17,908 | 13,789 | 4,473 | 4,476 | (9,858) | |

*Technology*

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

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

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

*Third Party Reinsurance*

Atlantic States, Southern and Donegal Mutual purchase reinsurance on a combined basis. Le Mars and Peninsula have separate reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. We use several different reinsurers, all of which, consistent with our requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating.

The following information relates to the external reinsurance Atlantic States, Southern and Donegal Mutual purchase includes:

- “excess of loss reinsurance,” under which our losses are automatically reinsured, through a series of contracts, over a set retention ($400,000 for 2005 with us having a 10% participation for losses up to $1.0 million), and
- “catastrophic reinsurance,” under which we recover, through a series of contracts, between 95% and 100% of an accumulation of many losses resulting from a single event, including natural disasters ($3.0 million retention for 2005).

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

Our principal third party reinsurance agreement in 2005 was a multi-line per risk excess of loss treaty with Partner Reinsurance Company, Dorinco Reinsurance Company, Hannover Ruckversicherungs-AG and Odyssey America Reinsurance Corporation that provides 90% coverage up to $1.0 million for both property and liability losses.

For property insurance, in 2005 we also had excess of loss treaties that provide for additional coverage over the multi-line treaty up to $2.5 million per occurrence. For liability insurance, we had excess of loss treaties that provide for additional coverage over the multi-line treaty up to $40.0 million per occurrence. For workers’ compensation insurance in 2005, we had excess of loss treaties that provide for additional coverage over the multi-line treaty up to $5.0 million on any one life. We entered into similar reinsurance treaties in 2006.

We have property catastrophe coverage through a series of layered treaties up to aggregate losses of $80.0 million for Atlantic States, Southern and Donegal Mutual for any single event. This coverage is provided through as many as twenty reinsurers on any one treaty with no reinsurer taking more than 20% of any one contract.

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

*Competition*

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

we face competition within agencies as well as competition to retain qualified independent agents.

*Investments*

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

At December 31, 2005, all of our debt securities were rated investment grade with the exception of one unrated obligation of $250,000, and the investment portfolio did not contain any mortgage loans or any non-performing assets.

The following table shows the composition of our debt securities investment portfolio (at carrying value), excluding short-term investments, by rating as of December 31, 2005:

| (dollars in thousands) | December 31, 2005 | |
|---|---|---|
| Rating(1) | Amount | Percent |
| U.S. Treasury and U.S. agency securities(2) | $ 168,432 | 35.4% |
| Aaa or AAA | 228,632 | 48.1 |
| Aa or AA | 54,432 | 11.4 |
| A | 14,633 | 3.1 |
| BBB | 8,900 | 1.9 |
| Not rated(3) | 250 | .1 |
| Total | $ 475,279 | 100.0% |

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

(2) Includes mortgage-backed securities of $58,837,961.

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

We invest in both taxable and tax-exempt securities as part of our strategy to maximize after-tax income, and are currently increasing our investments in tax-exempt securities. Our strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 41.6%, 46.2% and 55.8% of our debt securities investment portfolio at December 31, 2003, 2004 and 2005, respectively.

The following table shows the classification of our investments (at carrying value) at December 31, 2003, 2004 and 2005:

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2003 | | 2004 | | 2005 | |
| (dollars in thousands) | Amount | Percent of Total | Amount | Percent of Total | Amount | Percent of Total |
| Fixed maturities(1): | | | | | | |
| Held to maturity: | | | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 29,131 | 6.9% | $ 60,219 | 12.1% | $ 58,735 | 10.7% |
| Canadian government obligation | 499 | 0.1 | — | — | — | — |
| Obligations of states and political subdivisions | 45,188 | 10.7 | 76,652 | 15.4 | 84,656 | 15.5 |
| Corporate securities | 25,192 | 6.0 | 27,149 | 5.4 | 21,509 | 3.9 |
| Mortgage-backed securities | 13,041 | 3.1 | 18,554 | 3.7 | 15,282 | 2.8 |
| Total held to maturity | 113,051 | 26.8 | 182,574 | 36.6 | 180,182 | 32.9 |
| Available for sale: | | | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | 70,507 | 16.7 | 74,917 | 15.0 | 50,859 | 9.3 |
| Obligations of states and political subdivisions | 84,386 | 20.0 | 112,446 | 22.5 | 180,571 | 33.0 |
| Corporate securities | 30,699 | 7.3 | 31,352 | 6.3 | 20,112 | 3.7 |
| Mortgage-backed securities | 12,841 | 3.1 | 8,042 | 1.6 | 43,555 | 7.9 |
| Total available for sale | 198,433 | 47.1 | 226,757 | 45.4 | 295,097 | 53.9 |
| Total fixed maturities | 311,484 | 73.9 | 409,331 | 82.0 | 475,279 | 86.8 |
| Equity securities(2) | 24,710 | 5.9 | 33,505 | 6.7 | 33,371 | 6.1 |
| Investments in affiliates(3) | 6,738 | 1.6 | 8,865 | 1.8 | 8,442 | 1.5 |
| Short-term investments(4) | 78,344 | 18.6 | 47,368 | 9.5 | 30,654 | 5.6 |
| Total investments | $ 421,276 | 100.0% | $ 499,069 | 100.0% | $ 547,746 | 100.0% |

(1) We account for our investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting For Certain Investments in Debt and Equity Securities." See Notes 1 and 5 to the Consolidated Financial Statements incorporated by reference herein. Fixed maturities classified as held to maturity are valued at amortized cost; those fixed maturities classified as available for sale are valued at fair value. Total fair value of fixed maturities classified as held to maturity was $116.1 million at December 31, 2003, $184.7 million at December 31, 2004 and $178.6 million at December 31, 2005. The amortized cost of fixed maturities classified as available for sale was $192.1 million at December 31, 2003, $222.1 million at December 31, 2004 and $295.1 million at December 31, 2005.

(2) Equity securities are valued at fair value. Total cost of equity securities was $22.9 million at December 31, 2003, $30.8 million at December 31, 2004 and $29.0 million at December 31, 2005.

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

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

The following table sets forth the maturities (at carrying value) in our fixed maturity and short-term investment portfolio at December 31, 2003, December 31, 2004 and December 31, 2005:

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2003 | | 2004 | | 2005 | |
| (dollars in thousands) | Amount | Percent of Total | Amount | Percent of Total | Amount | Percent of Total |
| Due in(1): | | | | | | |
| One year or less | $ 92,396 | 23.7% | $ 61,837 | 13.5% | $ 55,717 | 11.0% |
| Over one year through three years | 46,840 | 12.0 | 67,440 | 14.8 | 60,852 | 12.0 |
| Over three years through five years | 64,331 | 16.5 | 88,910 | 19.5 | 59,006 | 11.7 |
| Over five years through ten years | 73,057 | 18.7 | 74,853 | 16.4 | 136,344 | 26.9 |
| Over ten years through fifteen years | 81,016 | 20.8 | 131,669 | 28.8 | 131,355 | 26.0 |
| Over fifteen years | 6,306 | 1.6 | 5,395 | 1.2 | 3,821 | 0.8 |
| Mortgage-backed securities | 25,882 | 6.7 | 26,596 | 5.8 | 58,838 | 11.6 |
| | $ 389,828 | 100.0% | $ 456,700 | 100.0% | $ 505,933 | 100.0% |

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

As shown above, we held investments in mortgage-backed securities having a carrying value of $58.8 million at December 31, 2005. Our mortgage-backed securities consist primarily of investments in governmental agency balloon pools with stated maturities between two and 25 years. The stated maturities of these investments limits our exposure to extension risk should interest rates rise and prepayments decline. We perform an analysis of the underlying loans when evaluating a mortgage-backed security for purchase, and we select those securities that we believe will provide a return that properly reflects the prepayment risk associated with the underlying loans.

Our investment results for the years ended December 31, 2003, 2004 and 2005 are shown in the following table:

| | Year Ended December 31, | | |
|---|---|---|---|
| (dollars in thousands) | 2003 | 2004 | 2005 |
| Invested assets(1) | $376,788 | $460,173 | $523,408 |
| Investment income(2) | 13,316 | 15,907 | 18,472 |
| Average yield | 3.5% | 3.5% | 3.5% |

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

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

*A.M. Best Rating*

Currently, the A.M. Best rating of our insurance subsidiaries and Donegal Mutual is A (Excellent), based upon their respective current financial condition and historical statutory results of operations and retrocessional agreements. We believe that our A.M. Best rating is an important factor in marketing our products to our agents and customers. A.M. Best's ratings are industry ratings based on a comparative analysis of the financial condition and operating performance of insurance companies. A.M. Best's classifications are A++ and A+ (Superior), A and A- (Excellent), B++ and B+ (Very Good), B and B- (Good), C++ and C+ (Fair), C and C- (Marginal), D (Below Minimum Standards) and E and F (Liquidation). A.M. Best's ratings are based upon factors relevant to the payment of claims of policyholders and are not directed toward the protection of investors in insurance companies. According to A.M. Best, the "Excellent" rating that Donegal Insurance Group maintains is assigned to those companies that, in A.M. Best's opinion, have an excellent ability to meet their ongoing obligations to policyholders.

*Regulation*

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

In addition to state-imposed insurance laws and regulations, the National Association of Insurance Commissioners ("NAIC") has established a risk-based capital system for assessing the adequacy of statutory capital and surplus that augments the states' current fixed dollar minimum capital requirements for insurance companies. At December 31, 2005, our insurance subsidiaries and Donegal Mutual each exceeded the minimum levels of statutory capital required by the risk-based capital rules. There can be no assurance that the statutory capital requirements applicable to our insurance subsidiaries or Donegal Mutual will not increase in the future.

Generally, every state has guaranty fund laws under which insurers licensed to do business in the state can be assessed on the basis of premiums written by the insurer in that state in order to fund policyholder liabilities of insolvent insurance companies. Under these laws in general, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of policyholder claims against insolvent insurers. Our insurance subsidiaries and Donegal Mutual have made accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations. During 2003 and 2004, we incurred assessments totaling $217,000 and $845,000, respectively, from the Pennsylvania Property and Casualty Insurance Guaranty Association ("PIGA") primarily relating to the insolvencies of three medical malpractice insurers and Reliance Insurance Company. Based from information provided by PIGA during 2005, we determined that the estimated assessment liability could be reduced, and we recognized a benefit of $1.4 million for assessments estimated and recorded in previous years.

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

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

Approval of the applicable insurance commissioner is also required prior to consummation of transactions affecting the control of an insurer. In some states, including Pennsylvania, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company creates a rebuttable presumption of a change in control. Pursuant to an order issued in April 2003, the Department approved Donegal Mutual's ownership of up to 70% of our outstanding Class A common stock and up to 100% of our outstanding Class B

common stock. Insurance holding company laws also require notice to the applicable insurance commissioner of certain material transactions between an insurer and any person in its holding company system and, in some states, certain of such transactions cannot be consummated without the prior approval of the applicable insurance commissioner.

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

Our insurance subsidiaries are restricted by the insurance laws of their respective states of domicile as to the amount of dividends or other distributions they may pay to us without the prior approval of the respective state regulatory authorities. Generally, the maximum amount that may be paid by an insurance subsidiary during any year after notice to, but without prior approval of, the insurance commissioners of these states is limited to a stated percentage of that subsidiary's statutory capital and surplus as of the end of the preceding year or the net income excluding realized capital gains of the subsidiary for the preceding year. As of December 31, 2005, the amount of dividends our insurance subsidiaries could pay us during 2006 without the prior approval of the various insurance commissioners was as follows:

| Name of Insurance Subsidiary | Ordinary Dividend Amount |
| --- | --- |
| Atlantic States Insurance Company | $21.9 million |
| Southern Insurance Company of Virginia | 5.4 million |
| Le Mars Insurance Company | 2.1 million |
| Peninsula Insurance Group | 2.9 million |

*Donegal Mutual*

Donegal Mutual was organized in 1889. At December 31, 2005, Donegal Mutual had admitted assets of $268.9 million and policyholders' surplus of $114.7 million. At December 31, 2005, Donegal Mutual had no debt and, of its total liabilities of $154.2 million,

reserves for net losses and loss expenses accounted for $62.8 million and unearned premiums accounted for $38.7 million. Of Donegal Mutual's investment portfolio of $189.3 million at December 31, 2005, investment-grade bonds accounted for $44.1 million and mortgages accounted for $3.3 million. At December 31, 2005, Donegal Mutual owned 5,968,411 shares, or approximately 42%, of our Class A common stock, which were carried on Donegal Mutual's books at $79.7 million, and 2,802,487 shares, or approximately 67%, of our Class B common stock, which were carried on Donegal Mutual's books at $37.4 million. The foregoing financial information is presented on the statutory basis of accounting required by the NAIC Accounting Practices and Procedures Manual. Donegal Mutual does not, nor is it required to, prepare financial statements in accordance with GAAP.

*Donegal Financial Services Corporation*

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

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

*Cautionary Statement Regarding Forward-Looking Statements*

This annual report and the documents incorporated by reference into this annual report contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies, reserves, profitability and business relationships and our other business activities during 2005 and beyond. In some cases, you can identify forward-looking statements by terms such as "may," "will," "should," "could," "would," "expect," "plan," "intend," "anticipate," "believe," "estimate,"

"objective," "project," "predict," "potential," "goal" and similar expressions. These forward-looking statements reflect our current views about future events, are based on our current assumptions and are subject to known and unknown risks and uncertainties that may cause our results, performance or achievements to differ materially from those anticipated in or implied by those statements. Many of the factors that will determine future events or achievements are beyond our ability to control or predict. Such factors may include those described under "Risk Factors." The forward-looking statements contained in this annual report reflect our views and assumptions only as of the date of this annual report. Except as required by law, we do not intend to, and assume no responsibility for, updating any forward-looking statements. We qualify all of our forward-looking statements by these cautionary statements.

*Available Information*

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and our other filings pursuant to the Securities Exchange Act of 1934 (the "Exchange Act") are available without charge on our website, www.donegalgroup.com, as soon as reasonably practicable after they are filed electronically with the Securities and Exchange Commission (the "SEC"). Our Code of Business Conduct and Ethics, and the charters of our Audit Committee and our Nominating Committee are available on our website. Upon request to our Corporate Secretary, printed copies are also available. We are providing the address to our Internet site solely for the information of investors. We do not intend the reference to our website address to be an active link or to otherwise incorporate the contents of the website into this report.

## Item 1A. Risk Factors.

*Risk Factors*

*Risks Relating to Us and Our Business*

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

Donegal Mutual, which currently owns shares of our common stock generally entitling it to cast approximately 61% of the aggregate votes eligible to be cast by our stockholders at any meeting of stockholders, controls the election of the members of our board of directors, and four of the seven members of our board of directors are also members of the board of directors of Donegal Mutual. These directors have a fiduciary duty to our stockholders, and also have a fiduciary duty to the policyholders of Donegal Mutual. Our executive officers have the same positions with both Donegal Mutual and us, and therefore

have competing fiduciary duties. Certain potential and actual conflicts of interest arise from these separate fiduciary duties. Among these conflicts of interest are:

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

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

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

Each share of our Class A common stock has one-tenth of a vote per share and generally can vote as a separate class only on matters pertaining to the rights of holders of Class A common stock. Voting control of the Company is vested in Donegal Mutual. As of February 27, 2006, Donegal Mutual owned approximately 42% of our outstanding Class A common stock and approximately 68% of our outstanding Class B common stock and controls approximately 61% of the votes that may be cast on any matter submitted to a vote of our stockholders. Donegal Mutual has sufficient voting control to:

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

The interests of Donegal Mutual may conflict with the interests of our other stockholders. In addition, the voting power of Donegal Mutual may have a negative effect on the price of our Class A common stock. From time to time, Donegal Mutual purchases our Class A common stock and Class B common stock on the Nasdaq National Market$^{SM}$ in accordance with the safe-harbor provisions of SEC Rule 10b-18 or in privately negotiated transactions.

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

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

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

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

We conduct business in states located primarily in the Mid-Atlantic, Midwestern and Southeastern portions of the United States. A substantial portion of our business is private passenger and commercial automobile, homeowners and workers' compensation insurance

in Pennsylvania, Maryland and Virginia. While we actively manage our exposure to catastrophes through our underwriting process and the purchase of reinsurance, a single catastrophe occurrence, destructive weather pattern, general economic trend, terrorist attack, regulatory development or other condition affecting one or more of the states in which we conduct substantial business could materially adversely affect our business, financial condition and results of operations. Common catastrophic events include hurricanes, earthquakes, tornadoes, wind and hail storms, fires, explosions and severe winter storms.

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

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

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

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

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

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

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

As a holding company, we rely primarily on dividends from our insurance subsidiaries as a source of funds to meet our corporate obligations. Payment of dividends by our insurance subsidiaries is subject to regulatory restrictions and depends on the surplus of our subsidiaries. From time to time, the NAIC and various state insurance regulators consider modifying the method of determining the amount of dividends that may be paid by an insurance company without prior regulatory approval. The maximum amount of ordinary dividends that our insurance subsidiaries can pay us in 2006 without prior regulatory approval is approximately $32.3 million. In addition, state insurance regulators have broad discretion to limit the payment of dividends by our insurance subsidiaries in the future. The ability of our insurance subsidiaries to pay dividends to us may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus that could affect our ratings, competitive position, the amount of premiums that we can write and our ability to pay future dividends.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The loss of, or failure to attract, key personnel could significantly impede our financial plans, growth, marketing and other objectives. Our success depends to a substantial extent

on the ability and experience of our senior management. We believe that our future success will depend in large part on our ability to attract and retain additional skilled and qualified personnel and to expand, train and manage our employees. We may not be successful in doing so, because the competition for experienced personnel in the insurance industry is intense. We do not have employment agreements with our key personnel, all of whom are employed by Donegal Mutual.

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

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which became law in July 2002, required changes in our corporate governance, public disclosure and compliance practices. Sarbanes-Oxley also required that the SEC promulgate new rules on a variety of corporate governance and disclosure subjects. In addition to these rules, the Nasdaq National Market℠ has adopted revisions to its requirements for companies listed on Nasdaq, like us. These developments have increased our legal and financial compliance costs.

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

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

We rely on reinsurance agreements to limit our maximum net loss from large single risks or risks in concentrated areas, and to increase our capacity to write insurance. Although the reinsurance we maintain provides that the reinsurer is liable to us, our reinsurance does not relieve us from liability to our policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable to us under the terms of its reinsurance agreement with us, we remain liable for such losses. As of December 31, 2005, we had approximately $32.3 million of reinsurance receivables from third-party reinsurers for paid and unpaid losses for which we believe we are entitled to reimbursement. The insolvency or inability to make timely payments by our reinsurers under the terms of our reinsurance agreements would adversely affect our results of operations.

In addition, we face a risk of the non-availability of reinsurance or an increase in reinsurance costs that could adversely affect our ability to write business or our results of operations. Market conditions beyond our control, such as the amount of surplus in the reinsurance market and natural and man-made catastrophes, affect the availability and cost of the reinsurance we purchase. We cannot assure you that reinsurance will remain available to us to the same extent and on substantially the same terms and rates as it is currently

available. If we are unable to maintain our current level of reinsurance or purchase new reinsurance protection in amounts that we consider sufficient, we would either have to be willing to accept an increase in our net retention or reduce our insurance writings, and our business, financial condition and results of operations could be adversely affected.

*Risks Relating to the Property and Casualty Insurance Industry*

*We face significant exposure to terrorism.*

As a result of the September 11, 2001 terrorist attacks, the insurance industry has been compelled to re-examine policy terms and conditions and to address the potential for future threats of terrorist attacks and resulting losses. Our personal and commercial property and casualty insurance policies are not priced to cover the risk of terrorist attacks and losses such as those suffered in the World Trade Center terrorist attack. Therefore, we have exposure to terrorism under the lines of insurance products that we offer. The Terrorism Risk Insurance Extension Act of 2005, or “TRIA,” may reduce the impact of future losses as a result of terrorism in connection with commercial insurance products we offer; however, because of the uncertainty regarding the application of the TRIA, the amount of losses we may be required to retain as a result of terrorism may result in a material adverse effect on our business, financial condition and results of operations. TRIA now has an expiration date of December 31, 2008, so it will not provide coverage beyond that time unless it is extended. While TRIA includes higher retention levels for insurers in 2006 and 2007, the program’s expiration at the end of 2008 will result in an increase in insurers’ loss retention in 2009. TRIA does not cover the personal insurance products we offer, and state regulators have not approved exclusions for acts of terrorism in our personal insurance products. Therefore we could incur large unexpected losses from the personal insurance policies that we issue, which could have a material adverse effect on our business, financial condition and results of operations.

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

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

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

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

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

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

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

The state insurance regulatory framework recently has come under increased federal scrutiny. Congress is considering legislation that would create an optional federal charter for insurers. Federal chartering has the potential to create an uneven playing field for insurers by subjecting federally-chartered and state-chartered insurers to different regulatory requirements. Federal chartering also raises the specter of a matrix of regulation and costly duplicative, or conflicting, federal and state requirements. In addition, if federal legislation

repeals the partial exemption for the insurance industry from federal antitrust laws, it would make it extremely difficult for insurers to compile and share loss data and predict future loss costs, which is an important part of cost-based pricing for insurers. If the ability to collect this data were removed, then the predictability of future loss costs, and hence, the reliability of our pricing, would be greatly undermined.

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

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

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

We are obligated to pay assessments under the guaranty fund laws of the various states in which we are licensed. Generally, under these laws, we are subject to assessment, depending upon our market share of a given line of insurance business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies in those states. The number and magnitude of future insurance company failures in the states in which we conduct business cannot be predicted, but resulting assessments could significantly affect our business, financial condition and results of operations.

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

One of the distinguishing features of the property and casualty insurance industry is that its products are priced before its costs are known, as premium rates are generally determined before losses are reported. Accordingly, we must establish premium rates from

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

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

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

*Risks Relating to Our Class A Common Stock*

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

Our Class A common stock has limited trading liquidity. Reported average daily trading volume in our Class A common stock for the year ended December 31, 2005 was approximately 21,551 shares. This limited trading liquidity subjects our shares of Class A common stock to greater price volatility.

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

The sale, or the availability for sale, of a significant number of shares of our Class A common stock or Class B common stock could adversely affect the prevailing market prices of our Class A common stock and could impair our ability to raise capital through future sales of our equity securities. As of February 27, 2006, we had outstanding 14,283,996 shares

of our Class A common stock and 4,182,684 shares of our Class B common stock. Apart from the shares held by Donegal Mutual, all of our outstanding shares of Class A common stock and Class B common stock are freely tradeable without restrictions under the Securities Act. Sales of a substantial number of shares of our Class A common stock or Class B common stock by Donegal Mutual could cause the price of our Class A common stock to fall.

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

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

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

## Item 1B. Unresolved Staff Comments.

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

## Item 2. Properties.

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

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

Item 3. Legal Proceedings.

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

During our fiscal year ended December 31, 2005, no tax shelter penalties were assessed against us by the Internal Revenue Service.

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

No matter was submitted to a vote of holders of our Class A common stock or Class B common stock during the fourth quarter of 2005.

Executive Officers of the Company

The following table sets forth information regarding the executive officers of the companies that comprise the Donegal Insurance Group, each of whom has served with us for more than 10 years:

| Name | Age | Position |
|---|---|---|
| Donald H. Nikolaus | 63 | President and Chief Executive Officer of Donegal Mutual since 1981; President and Chief Executive Officer of the Company since 1986. |
| Robert G. Shenk | 51 | Senior Vice President, Claims, of Donegal Mutual since 1997; Vice President, Claims, of Donegal Mutual from 1992 to 1997 and Manager, Casualty Claims, of Donegal Mutual from 1985 to 1992. |
| Cyril J. Greenya | 60 | Senior Vice President and Chief Underwriting Officer, of Donegal Mutual since 2005, Senior Vice President, Underwriting of Donegal Mutual from 1997 to 2005, Vice President, Commercial Underwriting, of Donegal Mutual from 1992 to 1997 and Manager, Commercial Underwriting of Donegal Mutual from 1983 to 1992. |
| Daniel J. Wagner | 44 | Senior Vice President and Treasurer of Donegal Mutual and the Company since 2005; Vice President and Treasurer of Donegal Mutual and the Company |

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| Name | Age | Position |
| --- | --- | --- |
| | | from 2000 to 2005; Treasurer of Donegal Mutual and the Company from 1993 to 2000; Controller of Donegal Mutual and the Company from 1988 to 1993. |
| Jeffrey D. Miller | 41 | Senior Vice President and Chief Financial Officer of Donegal Mutual and the Company since 2005; Vice President and Controller of Donegal Mutual and the Company from 2000 to 2005; Controller of Donegal Mutual and the Company from 1995 to 2000. |

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PART II

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

The response to this Item is incorporated in part by reference to page 40 of our Annual Report to Stockholders for the year ended December 31, 2005, which is included as Exhibit (13) to this Form 10-K Report. As of February 27, 2005, we had approximately 795 holders of record of our Class A common stock and 442 holders of record of our Class B common stock. We declared dividends of $0.36 per share on our Class A common stock and $0.32 per share on our Class B common stock in 2004 and $0.40 per share on our Class A common stock and $0.34 per share on our Class B common stock in 2005.

Between October 1, 2005 and December 31, 2005, we did not purchase any shares of our Class A common stock or Class B common stock. Between October 1, 2005 and December 31, 2005, Donegal Mutual purchased shares of our Class A common stock and Class B common stock as set forth in the following table.

| Period | (a) Total Number of Shares (or Units) Purchased | (b) Average Price Paid per Share (or Unit) | (c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| Month #1 | Class A – 113,333 | Class A – $22.48 | Class A –NONE | (1) |
| October 1-31, 2005 | Class B – NONE | Class B – NONE | Class B – NONE | |
| Month #2 | Class A – NONE | Class A – NONE | Class A – NONE | |
| November 1-30, 2005 | Class B – 667 | Class B – $21.90 | Class B – NONE | (1) |
| Month #3 | Class A – 95,000 | Class A – $23.27 | Class A – NONE | (1) |
| December 1-31, 2005 | Class B – 49,924 | Class B – $23.21 | Class B – 49,924 | (2) |
| Total | Class A – 208,333 | Class A – $22.84 | Class A – NONE | |
| | Class B – 50,591 | Class B – $23.19 | Class B – 49,924 | |

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

(2) These shares were purchased by Donegal Mutual pursuant to its announcement on August 17, 2004, that it will, at its discretion, purchase shares of our Class A common stock and Class B common stock at market

prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions with stockholders. Such announcement did not stipulate a maximum number of shares that may be purchased under this program.

Item 6. Selected Financial Data.

The response to this Item is incorporated by reference to page 8 of our Annual Report to Stockholders for the year ended December 31, 2005, which is included as Exhibit (13) to this Form 10-K Report.

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

The response to this Item is incorporated by reference to pages 10 through 18 of our Annual Report to Stockholders for the year ended December 31, 2005, which is included as Exhibit (13) to this Form 10-K Report.

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

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

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

*Interest Rate Risk*

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

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

| (amounts in thousands) | As of December 31, 2005 | |
|---|---|---|
| | Principal cash flows | Weighted-average interest rate |
| *Fixed maturities and short-term investments:* | | |
| 2006 | $ 55,928 | 2.2% |
| 2007 | 30,957 | 4.8 |
| 2008 | 33,399 | 4.2 |
| 2009 | 41,853 | 4.4 |
| 2010 | 28,402 | 4.6 |
| Thereafter | 304,838 | 4.8 |
| Total | $ 495,377 | |
| Market Value | $ 504,352 | |
| *Debt:* | | |
| 2033 | $ 30,929 | 8.3% |
| Total | $ 30,929 | |
| Fair Value | $ 30,929 | |

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

*Equity Price Risk*

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

*Credit Risk*

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

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

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

that a reinsurer may be unable to pay losses for which it is liable to us under the terms of its reinsurance agreement with us, we remain liable for such losses.

Item 8. Financial Statements and Supplementary Data.

The response to this Item is incorporated by reference to pages 19 through 36 of our Annual Report to Stockholders for the year ended December 31, 2005, which is included as Exhibit (13) to this Form 10-K Report.

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

None.

Item 9A. Controls and Procedures.

*Disclosure Controls and Procedures*

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

*Internal Control over Financial Reporting*

Pursuant to Section 404 of Sarbanes-Oxley, a report of management's assessment of the design and effectiveness of our internal controls is included as part of our Annual Report to Stockholders incorporated by reference in this Form 10-K Annual Report. KPMG LLP, an independent registered public accounting firm, audited the effectiveness of our internal control over financial reporting as of December 31, 2005 based on criteria establish by Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The report of KPMG dated March 13, 2006 is included as part of our Annual Report to Stockholders incorporated by reference in this Form 10-K Annual Report.

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*Changes in Internal Control over Financial Reporting*

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth quarter of 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information.

None.

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# PART III

## Item 10. Directors and Executive Officers of the Registrant.

The response to this Item with respect to our directors is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 20, 2006. The response to this Item with respect to our executive officers is incorporated by reference to Part I of this Form 10-K Report.

The full text of our Code of Ethics is included as Exhibit 14 to this Form 10-K Report.

## Item 11. Executive Compensation.

The response to this Item is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 20, 2006, except for the Report of our Compensation Committee, the Performance Graph and the Report of our Audit Committee, which are not incorporated herein by reference.

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

The response to this Item is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 20, 2006.

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

Equity Compensation Plan Information

| Plan category | Number of securities (class) to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of securities (class) remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c) |
|---|---|---|---|
| Equity compensation plans approved by securityholders | 735,802(Class A)<br>—(Class B) | $ 9.51(ClassA)<br>—(Class B) | 808,599(Class A)<br>—(Class B) |
| Equity compensation plans not approved by securityholders | — | — | — |
| Total | 735,802 | $ 9.51 | 808,599 |

Item 13. Certain Relationships and Related Transactions.

The response to this Item is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 20, 2006.

Item 14. Principal Accountant Fees and Services.

The response to this Item is incorporated by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 20, 2006.

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PART IV

Item 15. Exhibits and Financial Statement Schedules.

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

(a) Consolidated Financial Statements


| | Page* |
|---|---|
| Reports of Independent Registered Public Accounting Firm | 37, 39 |
| Donegal Group Inc. and Subsidiaries:<br>Consolidated Balance Sheets as of December 31, 2005 and 2004 | 19 |
| Consolidated Statements of Income and Comprehensive Income for the three years ended December 31, 2005, 2004 and 2003 | 20 |
| Consolidated Statements of Stockholders’ Equity for the three years ended December 31, 2005, 2004 and 2003 | 21 |
| Consolidated Statements of Cash Flows for the three years ended December 31, 2005, 2004 and 2003 | 22 |
| Notes to Consolidated Financial Statements | 23 |
| Report and Consent of Independent Registered Public Accounting Firm | Exhibit 23 |


(b) Financial Statement Schedules


| Donegal Group Inc. and Subsidiaries | Page |
|---|---|
| Schedule I. Summary of Investments – Other Than Investments in Related Parties | S-1 |
| Schedule II. Condensed Financial Information of Parent Company | S-2 |
| Schedule III. Supplementary Insurance Information | S-5 |
| Schedule IV. Reinsurance | S-7 |
| Schedule VI. Supplemental Insurance Information Concerning Property and Casualty Subsidiaries | S-8 |

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

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* Refers to pages of our 2005 Annual Report to Stockholders. The Consolidated Financial Statements and Notes to Consolidated Financial Statements, Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements, Management's Report on Internal Control over Financial Reporting and Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting on pages 19 through 39 are incorporated herein by reference. With the exception of the portions of such Annual Report specifically incorporated by reference in this Item and Items 5, 6, 7 and 8 hereof, such Annual Report shall not be deemed filed as part of this Form 10-K Report or otherwise subject to the liabilities of Section 18 of the Exchange Act.

(c) Exhibits

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

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| Exhibit No. | Description of Exhibits | Reference |
| --- | --- | --- |
| (10)(I) | Amendment No. 3 effective July 23, 2001 to Donegal Mutual Insurance Company 401(k) Plan. | (b) |
| (10)(J) | Amendment No. 4 effective January 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan. | (b) |
| (10)(K) | Amendment No. 5 effective December 31, 2001 to Donegal Mutual Insurance Company 401(k) Plan. | (b) |
| (10)(L) | Amendment No. 6 effective July 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan. | (r) |
| (10)(M) | Donegal Mutual Insurance Company Executive Restoration Plan. | (h) |
| Other Material Contracts | | |
| (10)(N) | Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company. | (i) |
| (10)(O) | Services Allocation Agreement dated September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company. | (i) |
| (10)(P) | Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company. | (i) |
| (10)(Q) | Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company. | (j) |
| (10)(R) | Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company. | (k) |
| (10)(S) | Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company. | (l) |

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| Exhibit No. | Description of Exhibits | Reference |
|---|---|---|
| (10)(T) | Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia. | (h) |
| (10)(U) | Amended and Restated Credit Agreement dated as of July 27, 1998 among Donegal Group Inc., the banks and other financial institutions from time to time party thereto and Fleet National Bank, as agent. | (m) |
| (10)(V) | First Amendment and Waiver to the Amended and Restated Credit Agreement dated as of December 31, 1999. | (g) |
| (10)(W) | Amendment dated as of April 20, 2000 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company. | (n) |
| (10)(X) | Lease Agreement dated as of September 1, 2000 between Donegal Mutual Insurance Company and Province Bank FSB. | (d) |
| (10)(Y) | Aggregate Excess of Loss Reinsurance Agreement dated as of January 1, 2001 between Donegal Mutual Insurance Company and Atlantic States Insurance Company (as successor-in-interest to Pioneer Insurance Company). | (d) |
| (10)(Z) | Plan of Conversion of Le Mars Mutual Insurance Company of Iowa adopted August 11, 2003 | (p) |
| (10)(AA) | Stock Purchase Agreement dated as of October 28, 2003 between Donegal Group Inc. and Folksamerica Holding Company, Inc. | (o) |
| (10)(BB) | Credit Agreement dated as of November 25, 2003 between Donegal Group Inc. and Manufacturers and Traders Trust Company | (p) |
| (13) | 2005 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K Report). | Filed herewith |
| (14) | Code of Ethics | (q) |
| (21) | Subsidiaries of Registrant. | Filed herewith |

| Exhibit No. | Description of Exhibits | Reference |
|---|---|---|
| (23) | Report and Consent of Independent Registered Public Accounting Firm | Filed herewith |
| (31.1) | Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer | Filed herewith |
| (31.2) | Rule 13a-14(a)/15(d)-14(a) Certification of Chief Financial Officer | Filed herewith |
| (32.1) | Section 1350 Certification of Chief Executive Officer | Filed herewith |
| (32.2) | Section 1350 Certificate of Chief Financial Officer | Filed herewith |

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

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

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

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

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

(f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 333-63102 declared effective February 8, 2002.

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

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

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

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

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

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

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

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

(o) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant’s Form 8-K Report dated November 3, 2003.

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

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

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SIGNATURES

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

DONEGAL GROUP INC.

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

Date: March 13, 2006

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<br>Donald H. Nikolaus | President and a Director<br>(principal executive officer) | March 13, 2006 |
| /s/ Jeffrey D. Miller<br>Jeffrey D. Miller | Senior Vice President and<br>Chief Financial Officer<br>(principal financial<br>and accounting officer) | March 13, 2006 |
| /s/ Robert S. Bolinger<br>Robert S. Bolinger | Director | March 13, 2006 |
| /s/ Patricia A. Gilmartin<br>Patricia A. Gilmartin | Director | March 13, 2006 |
| /s/ Philip H. Glatfelter, II<br>Philip H. Glatfelter, II | Director | March 13, 2006 |

| Signature | Title | Date |
| --- | --- | --- |
| /s/ John J. Lyons<br>John J. Lyons | Director | March 13, 2006 |
| R. Richard Sherbahn | Director | March , 2006 |
| /s/ Richard D. Wampler, II<br>Richard D. Wampler, II | Director | March 13, 2006 |

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DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE I – SUMMARY OF INVESTMENTS
OTHER THAN INVESTMENTS IN RELATED PARTIES
($ in thousands)
December 31, 2005

| | Cost | Fair Value | Amount at Which Shown in the Balance Sheet |
|---|---|---|---|
| Fixed Maturities: | | | |
| Held to maturity: | | | |
| United States government and governmental agencies and authorities | $ 58,736 | $ 56,866 | $ 58,736 |
| Obligations of states and political subdivisions | 84,656 | 85,462 | 84,656 |
| All other corporate bonds | 21,508 | 21,450 | 21,508 |
| Mortgage-backed securities | 15,282 | 14,823 | 15,282 |
| Total fixed maturities held to maturity | 180,182 | 178,601 | 180,182 |
| Available for sale: | | | |
| United States government and governmental agencies and authorities | 51,374 | 50,859 | 50,859 |
| Obligations of states and political subdivisions | 179,004 | 180,571 | 180,571 |
| All other corporate bonds | 20,329 | 20,112 | 20,112 |
| Mortgage-backed securities | 44,390 | 43,556 | 43,556 |
| Total fixed maturities available for sale | 295,097 | 295,098 | 295,098 |
| Total fixed maturities | 475,279 | 473,699 | 475,280 |
| Equity Securities: | | | |
| Preferred stocks: | | | |
| Banks | 6,974 | 6,915 | 6,915 |
| Industrial and miscellaneous | 875 | 890 | 890 |
| Total preferred stocks | 7,849 | 7,805 | 7,805 |
| Common stocks: | | | |
| Banks and insurance companies* | 11,769 | 11,771 | 11,771 |
| Industrial and miscellaneous | 18,299 | 22,236 | 22,236 |
| Total common stocks | 30,068 | 34,007 | 34,007 |
| Total equity securities | 37,917 | 41,812 | 41,812 |
| Short-term investments | 30,654 | 30,654 | 30,654 |
| Total investments | $ 543,850 | $ 546,165 | $ 547,746 |

* Includes investments in affiliates as discussed in Note 5 of the Notes to Consolidated Financial Statements.

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DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II — CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

Condensed Balance Sheets
($ in thousands)

December 31, 2005 and 2004

| | 2005 | 2004 |
|---|---|---|
| ASSETS | | |
| Fixed-maturity investments | $ 4,192 | $ 4,120 |
| Investment in subsidiaries (equity method) | 294,333 | 259,898 |
| Short-term investments | 9,431 | 5,585 |
| Cash | 938 | 1,581 |
| Property and equipment | 1,168 | 1,293 |
| Other | 1,110 | 3,226 |
| Total assets | $ 311,172 | $ 275,703 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Cash dividends declared to stockholders | $ 1,781 | $ 1,567 |
| Subordinated debentures | 30,929 | 30,929 |
| Other | 566 | 503 |
| Total liabilities | 33,276 | 32,999 |
| Stockholders' equity | 277,896 | 242,704 |
| Total liabilities and stockholders' equity | $ 311,172 | $ 275,703 |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II — CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

(Continued)

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

Years Ended December 31, 2005, 2004 and 2003

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| **Statements of Income** | | | |
| Revenues | | | |
| Dividends from subsidiaries | $ 2,000 | $ 950 | $ 7,000 |
| Other | 1,276 | 1,242 | 1,034 |
| Total revenues | 3,276 | 2,192 | 8,034 |
| Expenses | | | |
| Operating expenses | 1,675 | 1,700 | 1,345 |
| Interest | 2,267 | 1,614 | 1,320 |
| Total expenses | 3,942 | 3,314 | 2,665 |
| Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries | (666) | (1,122) | 5,369 |
| Income tax benefit | (862) | (727) | (634) |
| Income (loss) before equity in undistributed net income of subsidiaries | 196 | (395) | 6,003 |
| Equity in undistributed net income of subsidiaries | 36,753 | 32,009 | 12,291 |
| Net income | $ 36,949 | $ 31,614 | $ 18,294 |
| **Statements of Comprehensive Income** | | | |
| Net income | $ 36,949 | $ 31,614 | $ 18,294 |
| Other comprehensive income (loss), net of tax | | | |
| Unrealized gain (loss) — parent | (25) | (2) | (42) |
| Unrealized gain (loss) — subsidiaries | (2,192) | (539) | 421 |
| Other comprehensive income (loss) | (2,217) | (541) | 379 |
| Comprehensive income | $ 34,732 | $ 31,073 | $ 18,673 |

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DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II — CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

(Continued)

Condensed Statements of Cash Flows
($ in thousands)

Years Ended December 31, 2005, 2004 and 2003

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $ 36,949 | $ 31,614 | $ 18,294 |
| Adjustments: | | | |
| Equity in undistributed net income of subsidiaries | (36,753) | (32,009) | (12,291) |
| Other | 4,446 | 731 | (4,137) |
| Net adjustments | (32,307) | (31,278) | (16,428) |
| Net cash provided | 4,642 | 336 | 1,866 |
| Cash flows from investing activities: | | | |
| Net purchase of fixed maturities | — | (2,084) | (1,938) |
| Net sale (purchase) of short-term investments | (3,846) | 41,974 | (47,559) |
| Net purchase of property and equipment | (392) | (246) | (433) |
| Investment in subsidiaries | — | (45,216) | (14,274) |
| Other | 215 | 334 | (981) |
| Net cash used | (4,023) | (5,238) | (65,185) |
| Cash flows from financing activities: | | | |
| Cash dividends paid | (6,813) | (5,985) | (3,868) |
| Issuance of common stock | 5,551 | 6,948 | 60,974 |
| Issuance of subordinated debentures | — | 5,155 | 25,774 |
| Line of credit, net | — | — | (19,800) |
| Net cash provided (used) | (1,262) | 6,118 | 63,080 |
| Net change in cash | (643) | 1,216 | (239) |
| Cash at beginning of year | 1,581 | 365 | 604 |
| Cash at end of year | $ 938 | $ 1,581 | $ 365 |

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

| 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, 2005 | | | | | | |
| Personal lines | $ 181,787 | — | $ 107,788 | $ 29,156 | $ 29,113 | $ 184,828 |
| Commercial lines | 112,711 | — | 59,754 | 18,078 | 18,050 | 117,716 |
| Investments | — | $ 18,472 | — | — | — | — |
| | $ 294,498 | $ 18,472 | $ 167,542 | $ 47,234 | $ 47,163 | $ 302,544 |
| Year Ended December 31, 2004 | | | | | | |
| Personal lines | $ 167,401 | $ — | $ 104,664 | $ 24,832 | $ 26,790 | $ 176,156 |
| Commercial lines | 98,438 | — | 59,477 | 14,602 | 15,754 | 107,126 |
| Investments | — | 15,907 | — | — | — | — |
| | $ 265,839 | $ 15,907 | $ 164,141 | $ 39,434 | $ 42,544 | $ 283,282 |
| Year Ended December 31, 2003 | | | | | | |
| Personal lines | $ 125,322 | $ — | $ 85,057 | $ 19,639 | $ 18,268 | $ 125,777 |
| Commercial lines | 71,471 | — | 41,186 | 11,200 | 10,418 | 68,727 |
| Investments | — | 13,316 | — | — | — | — |
| | $ 196,793 | $ 13,316 | $ 126,243 | $ 30,839 | $ 28,686 | $ 194,504 |

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

| | At December 31, | | | |
|---|---|---|---|---|
| Segment | Deferred Policy Acquisition Costs | Liability For Losses And Loss Expenses | Unearned Premiums | Other Policy Claims and Benefits Payable |
| 2005 | | | | |
| Personal lines | $ 13,922 | $ 119,313 | $ 110,689 | $ — |
| Commercial lines | 9,555 | 146,417 | 75,971 | — |
| Investments | — | — | — | — |
| | $ 23,477 | $ 265,730 | $ 186,660 | $ — |
| 2004 | | | | |
| Personal lines | $ 13,488 | $ 126,648 | $ 105,722 | $ — |
| Commercial lines | 8,770 | 140,542 | 68,736 | — |
| Investments | — | — | — | — |
| | $ 22,258 | $ 267,190 | $ 174,458 | $ — |

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, 2005 | | | | | |
| Property and casualty premiums | $209,693,968 | $97,377,704 | $182,181,759 | $294,498,023 | 62% |
| Year Ended December 31, 2004 | | | | | |
| Property and casualty premiums | $188,665,453 | $90,880,931 | $168,054,072 | $265,838,594 | 63% |
| Year Ended December 31, 2003 | | | | | |
| Property and casualty premiums | $114,154,202 | $70,429,560 | $153,068,054 | $196,792,696 | 78% |

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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, | | | | |
| 2005 | $23,476,593 | $265,729,527 | $ — | $186,660,050 |
| 2004 | $22,257,760 | $267,190,060 | $ — | $174,458,423 |
| 2003 | $16,223,765 | $217,914,057 | $ — | $134,028,035 |

(continued)

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI — SUPPLEMENTARY INSURANCE INFORMATION
CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES, CONTINUED
Years ended December 31, 2005, 2004 and 2003

| | | | Losses and Loss Expenses Related to | | | | |
|---|---|---|---|---|---|---|---|
| | Net Earned Premiums | Investment Income | Current Year | Prior Years | Amortization of Deferred Policy Acquisition Cost | Net Paid Losses and Loss Expenses | Net Premiums Written |
| Year Ended December 31, 2005 | $ 294,498,023 | $ 18,471,963 | $ 176,924,029 | $ (9,382,132) | $ 47,234,000 | $ 165,963,580 | $ 302,543,888 |
| Year Ended December 31, 2004 | $ 265,838,594 | $ 15,906,728 | $ 171,384,964 | $ (7,243,596) | $ 39,434,000 | $ 160,450,011 | $ 283,282,437 |
| Year Ended December 31, 2003 | $ 196,792,696 | $ 13,315,936 | $ 126,693,421 | $ (450,110) | $ 30,839,000 | $ 118,455,674 | $ 206,980,626 |

## Selected Consolidated Financial Data

| Year Ended December 31, | 2005 | 2004* | 2003* | 2002* | 2001* |
|---|---|---|---|---|---|
| Income Statement Data | | | | | |
| Premiums earned | $294,498,023 | $265,838,594 | $196,792,696 | $185,841,193 | $167,769,854 |
| Investment income, net | 18,471,963 | 15,906,728 | 13,315,936 | 14,581,252 | 15,885,544 |
| Realized investment gains (losses) | 1,802,809 | 1,466,220 | 1,368,031 | 144,190 | (880,254) |
| Total revenues | 319,847,194 | 287,788,638 | 214,992,328 | 203,803,561 | 185,163,623 |
| Income before income taxes and extraordinary gain | 52,345,495 | 37,054,251 | 25,436,375 | 16,494,584 | 7,091,729 |
| Income taxes | 15,395,998 | 10,885,652 | 7,142,399 | 4,491,862 | 1,273,598 |
| Extraordinary gain | — | 5,445,670 | — | — | — |
| Net income | 36,949,497 | 31,614,269 | 18,293,976 | 12,002,722 | 5,818,131 |
| Basic earnings per common share | 2.05 | 1.80 | 1.43 | .99 | .49 |
| Diluted earnings per common share | 1.98 | 1.74 | 1.39 | .98 | .48 |
| Cash dividends per share of Class A common stock | .40 | .36 | .32 | .30 | .30 |
| Cash dividends per share of Class B common stock | .34 | .32 | .29 | .27 | .27 |
| Balance Sheet Data at Year End | | | | | |
| Total investments | $547,746,114 | $499,069,332 | $421,276,467 | $332,299,094 | $300,633,355 |
| Total assets | 781,421,588 | 735,415,401 | 602,036,042 | 501,218,164 | 456,632,372 |
| Debt obligations | 30,929,000 | 30,929,000 | 25,774,000 | 19,800,000 | 27,600,000 |
| Stockholders’ equity | 277,896,186 | 242,704,314 | 208,649,232 | 133,182,850 | 120,928,349 |
| Stockholders’ equity per share | 15.07 | 13.53 | 12.22 | 10.89 | 10.08 |

*Per share information has been restated to reflect a 4-for-3 stock split effected in the form of a 33 1/3% stock dividend on March 28, 2005.

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

## General

We were organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") on August 26, 1986. We operate predominantly as an underwriter of personal and commercial lines of property and casualty insurance through our subsidiaries. Our personal lines products consist primarily of homeowners and private passenger automobile policies. Our commercial lines products consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies. Our insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Le Mars Insurance Company ("Le Mars") and the Peninsula Insurance Group ("Peninsula"), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in the Mid-Atlantic, Midwest and Southern states. We acquired Le Mars and Peninsula on January 1, 2004, and their results of operations have been included in our consolidated results of operations from that date. We also own 48.1% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a thrift holding company. The Mutual Company owns the remaining 51.9% of the outstanding stock of DFSC.

At December 31, 2005, the Mutual Company held approximately 42% of our outstanding Class A common stock and approximately 67% of our outstanding Class B common stock. We refer to the Mutual Company and our insurance subsidiaries as the Donegal Insurance Group.

On February 17, 2005, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33 1/3% stock dividend with a record date of March 1, 2005 and a distribution date of March 28, 2005. The capital stock accounts, all share amounts and earnings per share amounts for 2004 and prior years have been restated to reflect this stock split.

On September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, "Shelby"), part of Vesta Insurance Group, Inc. The agreement grants those members the right, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby's personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby's plans of withdrawal from those three states. As part of the agreement, the Donegal Insurance Group will pay specified amounts to Shelby based on the direct premiums written by the Donegal Insurance Group on the renewal and replacement policies it issues. Renewal and replacement policies will be offered for policies issued on or after January 1, 2006. Thus, the agreement had no impact on our 2005 operating results.

## Pooling Arrangement and Other Transactions with Affiliates

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

Since 1986, we have effected three public offerings, a major purpose of which was to provide capital for Atlantic States and our other insurance subsidiaries and to fund acquisitions. As Atlantic States received additional capital, its underwriting capacity significantly increased. Thus, as originally planned in the mid-1980s, Atlantic States had the capital necessary to support the growth of its direct business and increases in the amount and percentage of business it assumes from the pool. As a result, the participation of Atlantic States in the inter-company pool has increased periodically from its initial 30% participation in 1986 to its current 70% participation, and the size of the pool has steadily increased. The corresponding benefit to the Mutual Company has been the substantial increase in the Mutual Company's surplus and the significant growth of its overall business.

Our insurance operations are interrelated with the insurance operations of the Mutual Company, and, while maintaining the separate corporate existence of each company, the Mutual Company and we conduct our insurance business together with our other insurance subsidiaries as the Donegal Insurance Group. As such, the Mutual Company and we share the same business philosophy, management, employees and facilities and offer the same types of insurance products. We do not anticipate any changes in the pooling agreement with the Mutual Company, including changes in Atlantic States' pool participation level, in the foreseeable future.

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

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

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

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

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

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

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

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

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

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

There were no significant changes to the pooling agreement or other reinsurance agreements with the Mutual Company during 2005 and 2004 except as noted above.

**Critical Accounting Policies and Estimates**

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

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

**Liability for Losses and Loss Expenses**

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

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

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

the amount recorded at December 31, 2005. For every 1% change in our estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately $1.7 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that our ultimate liability will not exceed our loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to our estimated future liabilities cannot be predicted, since the historical conditions and events that serve as a basis for our estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, we have found it necessary in the past to increase our estimated future liabilities for losses and loss expenses in certain periods, and in other periods our estimates have exceeded our actual liabilities. Changes in our estimate of the liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. We recognized a decrease in our liability for losses and loss expenses of prior years of $9.4 million, $7.2 million and $450,110 in 2005, 2004 and 2003, respectively. Generally, we experienced improving loss development trends in 2005 and 2004, which were reflected in favorable settlements of open claims. We made no significant changes in our reserving philosophy, key reserving assumptions or claims management, and there have been no significant offsetting changes in estimates that increased or decreased the loss and loss expense reserves in these periods. The 2005 development was primarily recognized in the private passenger automobile liability, workers' compensation and commercial multi-peril lines of business and was consistently favorable for settlements of claims occurring in each of the previous five accident years. The majority of the 2005 development was related to decreases in the liability for losses and loss expenses of prior years for Atlantic States. Included in the 2004 development are decreases in the liability for losses and loss expenses of prior years for Le Mars and Peninsula of $3.6 million and $1.4 million, respectively, largely due to favorable settlement of open claims in the private passenger automobile liability line of business.

Excluding the impact of isolated catastrophic weather events, we have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to our premium base in recent years across most of our lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic conditions extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims. Further adjustments to our estimates could be required in the future. However, on the basis of our internal procedures, which analyze, among other things, our prior assumptions, our experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that we have made adequate provision for our liability for losses and loss expenses.

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

Our liability for losses and loss expenses by major line of business as of December 31, 2005 and 2004 consisted of the following:

| (in thousands) | 2005 | 2004 |
|---|---|---|
| Commercial lines: | | |
| Automobile | $ 23,532 | $ 22,656 |
| Workers' compensation | 40,962 | 37,995 |
| Commercial multi-peril | 29,448 | 27,867 |
| Other | 3,088 | 3,315 |
| Total commercial lines | 97,030 | 91,833 |
| Personal lines: | | |
| Automobile | 63,254 | 67,276 |
| Homeowners | 10,900 | 10,449 |
| Other | 1,825 | 1,873 |
| Total personal lines | 75,979 | 79,598 |
| Total commercial and personal lines | 173,009 | 171,431 |
| Plus reinsurance recoverable | 92,721 | 95,759 |
| Total liability for losses and loss expenses | $ 265,730 | $ 267,190 |

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

| Change in Loss and Loss Expense Reserves Net of Reinsurance | Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2005 | Percentage Change in Equity as of December 31, 2005(1) | Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2004 | Percentage Change in Equity as of December 31, 2004(1) |
|---|---|---|---|---|
| (10.0)% | $ 155,708 | 4.0% | $ 154,288 | 4.6% |
| (7.5) | 160,033 | 3.0 | 158,574 | 3.4 |
| (5.0) | 164,359 | 2.0 | 162,859 | 2.3 |
| (2.5) | 168,684 | 1.0 | 167,145 | 1.1 |
| Base | 173,009 | — | 171,431 | — |
| 2.5 | 177,334 | -1.0 | 175,717 | -1.1 |
| 5.0 | 181,659 | -2.0 | 180,003 | -2.3 |
| 7.5 | 185,985 | -3.0 | 184,288 | -3.4 |
| 10.0 | 190,310 | -4.0 | 188,574 | -4.6 |

(1) Net of income tax effect.

Our reserve for unpaid losses and loss expenses is based on current trends in loss and loss expense development and reflects our best estimate for future amounts needed to pay losses and loss expenses with respect to incurred events currently known to us plus incurred but not reported (“IBNR”) claims. Reserve estimates are based on management’s assessment of known facts and circumstances, review of historical loss settlement patterns, estimates of trends in claims severity, frequency, legal and regulatory changes and other assumptions. Actuarial loss reserving techniques and assumptions, which rely on historical information as

adjusted to reflect current conditions, have been consistently applied, including consideration of recent case reserve activity. For the year ended December 31, 2005, we used the most-likely number as determined by our actuaries. Based upon information provided by our actuaries during the development of our net reserves for losses and loss expenses for the year ended December 31, 2005, we developed a range from a low of $156.8 million to a high of $189.2 million and with a most-likely number of $173.0 million. The range of estimates for commercial lines in 2005 was $87.9 million to $106.1 million (we selected the actuaries' most-likely number of $97.0 million) and for personal lines in 2005 was $68.9 million to $83.1 million (we selected the actuaries' most-likely number of $76.0 million). Based upon information provided by our actuaries during the development of our net reserves for losses and loss expenses for the year ended December 31, 2004, we developed a range from a low of $125.1 million to a high of $215.6 million and with a most-likely number of $171.4 million. The range of estimates for commercial lines in 2004 was $68.1 million to $115.2 million (we selected the actuaries' most-likely number of $91.8 million) and for personal lines in 2004 was $57.0 million to $100.4 million (we selected the actuaries' most-likely number of $79.6 million).

We seek to enhance our underwriting results by carefully selecting the product lines we underwrite. For our personal lines products, we insure standard and preferred risks in private passenger automobile and homeowners lines. For our commercial lines products, the commercial risks that we primarily insure are mercantile risks, business offices, wholesalers, service providers, contractors and artisan risks, limiting industrial and manufacturing exposures. We have limited exposure to asbestos and other environmental liabilities. We write no medical malpractice or professional liability risks. Through the consistent application of this disciplined underwriting philosophy, we have avoided many of the "long-tail" issues faced by other insurance companies. We consider workers' compensation to be a "long-tail" line of business, in that workers' compensation claims tend to be settled over a longer timeframe than those in our other lines of business. The following table presents 2005 and 2004 claim count and payment amount information for workers' compensation. Workers' compensation losses primarily consist of indemnity and medical costs for injured workers. Substantially all of the claims are relatively small individual claims of a similar type.

| | For Year Ended December 31, | |
|---|---|---|
| | 2005 | 2004 |
| | (dollars in thousands) | |
| Number of claims pending, beginning of period | 1,676 | 1,808 |
| Number of claims reported | 3,865 | 1,926 |
| Number of claims settled or dismissed | 3,817 | 2,058 |
| Number of claims pending, end of period | 1,724 | 1,676 |
| Losses paid | $ 15,297 | $ 14,341 |
| Loss expenses paid | 3,203 | 2,755 |

**Investments**

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

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

During 2005, we sold bonds that had been classified as held to maturity due to significant deterioration in the issuer's creditworthiness. These bonds had an amortized cost of $1.0 million, and the sale resulted in a realized loss of $144,047. During 2003, we sold certain bonds that had been classified as held to maturity due to a series of rating agency downgrades related to these securities. These bonds had an amortized cost of $1.8 million, and the sale resulted in a realized gain of $165,564. There were no other sales or transfers from the held to maturity portfolio in 2005, 2004 or 2003.

**Policy Acquisition Costs**

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

**Management Evaluation of Operating Results**

Our premium growth rate and underwriting results have been, and continue to be, influenced by strong market conditions in the regions in which we conduct business. Increased industry pricing in recent years for commercial and personal insurance has allowed us and many other insurers to obtain higher premiums for our products while maintaining our competitive position in the insurance marketplace.

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

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

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

| | Year Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2005 | 2004 | 2003 |
| Net premiums written: | | | |
| Personal lines: | | | |
| Automobile | $ 122,059 | $ 118,734 | $ 86,644 |
| Homeowners | 52,149 | 47,540 | 36,989 |
| Other | 10,620 | 9,882 | 6,753 |
| Total personal lines | 184,828 | 176,156 | 130,386 |
| Commercial lines: | | | |
| Automobile | 34,641 | 32,679 | 18,655 |
| Workers’ compensation | 33,154 | 29,228 | 25,627 |
| Commercial multi-peril | 46,406 | 42,253 | 30,199 |
| Other | 3,515 | 2,966 | 2,114 |
| Total commercial lines | 117,716 | 107,126 | 76,595 |
| Total net premiums written | $ 302,544 | $ 283,282 | $ 206,981 |
| Components of GAAP combined ratio: | | | |
| Loss ratio | 56.9% | 61.7% | 64.2% |
| Expense ratio | 32.1 | 30.9 | 30.2 |
| Dividend ratio | 0.5 | 0.5 | 0.6 |
| GAAP combined ratio | 89.5% | 93.1% | 95.0% |
| Revenues: | | | |
| Premiums earned: | | | |
| Personal lines | $ 181,787 | $ 169,322 | $ 125,322 |
| Commercial lines | 112,711 | 99,657 | 71,471 |
| Total SAP premiums earned | 294,498 | 268,979 | 196,793 |
| GAAP adjustments | — | (3,140) | — |
| Total GAAP premiums earned | 294,498 | 265,839 | 196,793 |
| Net investment income | 18,472 | 15,907 | 13,316 |
| Realized investment gains | 1,803 | 1,466 | 1,368 |
| Other | 5,074 | 4,577 | 3,515 |
| Total revenues | $ 319,847 | $ 287,789 | $ 214,992 |
| Components of net income: | | | |
| Underwriting income: | | | |
| Personal lines | $ 14,232 | $ 10,100 | $ 2,004 |
| Commercial lines | 13,941 | 6,209 | 7,173 |
| SAP underwriting income | 28,173 | 16,309 | 9,177 |
| GAAP adjustments | 2,765 | 2,109 | 692 |
| GAAP underwriting income | 30,938 | 18,418 | 9,869 |
| Net investment income | 18,472 | 15,907 | 13,316 |
| Realized investment gains | 1,803 | 1,466 | 1,368 |
| Other | 1,132 | 1,263 | 883 |
| Income before income tax expense and extraordinary item | 52,345 | 37,054 | 25,436 |
| Income tax expense | (15,396) | (10,886) | (7,142) |
| Income before extraordinary item | 36,949 | 26,168 | 18,294 |
| Extraordinary gain | — | 5,446 | — |
| Net income | $ 36,949 | $ 31,614 | $ 18,294 |

**Results of Operations**
**Years Ended December 31, 2005 and 2004**

**Net Premiums Written**

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

**Net Premiums Earned**

Our net premiums earned increased to $294.5 million for 2005, an increase of $28.7 million, or 10.8%, over 2004. Our net earned premiums during 2005 have grown due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of our policies, which are generally one year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelve month period compared to the same period one year earlier.

**Investment Income**

For 2005, our net investment income increased 16.4% to $18.5 million, compared to $15.9 million for 2004. An increase in our average invested assets from $460.2 million in 2004 to $523.4 million in 2005 primarily accounted for the increase in investment income in 2005 compared to 2004. Our annualized average return was 3.5% during both years. Although we realized increases in our annualized average return as a result of a shift from short-term investments to higher yielding fixed maturities in our investment portfolio as well as higher short-term interest rates during 2005 compared to 2004, these increases were offset by decreases in our annualized average return on increased holdings of tax-exempt fixed maturities in our investment portfolio during 2005. The increased holdings of tax-exempt fixed maturities in 2005 resulted from a shift from taxable to tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

**Installment Payment Fees**

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

**Net Realized Investment Gains/Losses**

Our net realized investment gains in 2005 were $1.8 million, compared to $1.5 million in 2004. Our net realized investment gains in 2005 were net of impairment charges of $409,432, compared to impairment charges of $6,650 recognized in 2004. Our impairment charges for both years were the result of declines in the market value of equity securities that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

**Losses and Loss Expenses**

Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in 2005 was 56.9%, compared to 61.7% in 2004. Our commercial lines loss ratio decreased to 53.0% in 2005, compared to

60.4% in 2004. This decrease primarily resulted from the workers' compensation loss ratio decreasing to 68.0% in 2005, compared to 87.2% in 2004. The personal lines loss ratio improved from 62.5% in 2004 to 59.3% in 2005, primarily as a result of improvement in the personal automobile loss ratio to 62.4% in 2005, compared to 65.5% in 2004, and improvement in the homeowners loss ratio to 54.9% in 2005, compared to 56.4% in 2004. Improvements in our 2005 loss ratios reflect the benefits of premium pricing increases, decreased claim frequency and favorable prior accident year loss development of $9.4 million in 2005, compared to favorable development of $7.2 million in 2004. Favorable prior accident year loss development in both years was largely due to favorable settlements of open claims. The 2004 workers' compensation loss ratio was adversely impacted by reserve strengthening based upon past development trends in this line of business.

**Underwriting Expenses**

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

**Combined Ratio**

Our combined ratio was 89.5% and 93.1% in 2005 and 2004, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned. The improvement in our combined ratio was attributable to the decrease in the loss ratio between years.

**Interest Expense**

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

**Income Taxes**

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

**Net Income and Earnings Per Share**

Our net income in 2005 was $36.9 million, an increase of 16.8% over the $31.6 million reported in 2004. Our diluted earnings per share were $1.98 in 2005, compared to $1.74 in 2004. Our net income for 2004 included an extraordinary gain of $5.4 million, or $.30 per share on a diluted basis, related to an acquisition. Our fully diluted shares outstanding for 2005 increased to 18.6 million, compared to 18.2 million for 2004.

**Book Value Per Share and Return on Equity**

Our stockholders' equity increased by $35.2 million in 2005, primarily as a result of favorable operating results. Book value per share increased by 11.4% to $15.07 at December 31, 2005, compared to $13.53 a year earlier. Our return on average equity was 14.2% in 2005, compared to 14.0% in 2004.

**Years Ended December 31, 2004 and 2003**

**Net Premiums Written**

Our 2004 net premiums written increased by 36.9% to $283.3 million, compared to $207.0 million for 2003. Net premiums written by Le Mars and Peninsula were $58.8 million in 2004, representing 77% of our written premium growth for the year. Commercial lines net premiums written increased $30.5 million, or 39.9%, for 2004 compared to 2003. Personal lines net premiums written increased $45.8 million, or 35.1%, for 2004 compared to 2003. Excluding net premiums written by Le Mars and Peninsula, commercial lines net premiums written increased $11.4 million, or 14.9%, for 2004 compared to 2003, and personal lines net premiums written increased $6.1 million, or 4.7%, for 2004 compared to 2003. We have benefited during these periods from premium increases by our insurance subsidiaries that resulted from pricing actions approved by regulators. These increases, which related primarily to commercial lines of business in 2004, were realized in most of the states in which we operate. In addition to acquisition growth and pricing increases, we have also benefited from organic growth in most of the states in which we operate.

**Net Premiums Earned**

Our net premiums earned increased to $265.8 million for 2004, an increase of $69.0 million, or 35.1%, over 2003. Our net earned premiums during 2004 have grown due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of our policies, which are generally one year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the same period one year earlier.

**Investment Income**

For 2004, our net investment income increased 19.5% to $15.9 million, compared to $13.3 million for 2003. An increase in our average invested assets from $376.8 million in 2003 to $460.2 million in 2004 accounted for the increase in investment income in 2004 compared to 2003. Our annualized average return was 3.5% during both years.

**Installment Payment Fees**

Our installment fees increased in 2004 primarily as a result of our January 1, 2004 acquisitions and, to a lesser extent, due to increases in fee rates and policy counts during 2004.

**Net Realized Investment Gains/Losses**

Our net realized investment gains in 2004 were $1.5 million, compared to $1.4 million in 2003. Our net realized investment gains in 2004 were net of impairment charges of $6,650, compared to impairment charges of $237,724 recognized in 2003. Our impairment charges for both years were the result of

declines in the market value of equity securities that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

**Losses and Loss Expenses**

Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in 2004 was 61.7%, compared to 64.2% in 2003. Our commercial lines loss ratio increased to 60.4% in 2004, compared to 57.7% in 2003. This increase primarily resulted from the commercial automobile loss ratio increasing to 53.9% in 2004, compared to 51.9% in 2003, and the workers' compensation loss ratio increasing to 87.2% in 2004, compared to 60.5% in 2003. The personal lines loss ratio improved from 67.8% in 2003 to 62.5% in 2004, primarily as a result of improvement in the personal

automobile loss ratio to 65.5% in 2004, compared to 69.9% in 2003, and improvement in the homeowners loss ratio to 56.4% in 2004, compared to 65.5% in 2003. The increase in our 2004 workers' compensation loss ratio resulted from reserve strengthening based upon recent development trends in this line of business. Improvements in our 2004 loss ratios reflect the benefits of premium pricing increases as well as favorable prior accident year loss development of $7.2 million in 2004, compared to favorable development of $450,110 in 2003. Included in the 2004 development are decreases in the liability for losses and loss expenses of prior years for Le Mars and Peninsula of $3.6 million and $1.4 million, respectively, largely due to favorable settlements of open claims.

**Underwriting Expenses**

Our expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, in 2004 was 30.9%, compared to 30.2% in 2003. Improvements from expense control efforts were offset by higher underwriting-based incentive costs incurred in 2004 compared to 2003.

**Combined Ratio**

Our combined ratio was 93.1% and 95.0% in 2004 and 2003, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned. The improvement in our combined ratio was attributable to the decrease in the loss ratio between years.

**Interest Expense**

Our interest expense in 2004 was $1.6 million, compared to $1.3 million in 2003, reflecting an increase in interest expense related to the issuance of an additional $5.2 million of subordinated debentures in 2004 and increases in the average interest rates on our subordinated debentures compared to 2003.

**Income Taxes**

Our income tax expense was $10.9 million in 2004, compared to $7.1 million in 2003, representing effective tax rates of 29.4% and 28.1%, respectively. The change between effective tax rates is due to tax-exempt interest representing a smaller proportion of income before taxes in 2004 compared to 2003.

**Net Income and Earnings Per Share**

Our net income in 2004 was $31.6 million, an increase of 72.8% over the $18.3 million reported in 2003. Our diluted earnings per share were $1.74 in 2004, compared to $1.39 in 2003. Our net income for 2004 included an extraordinary gain of $5.4 million, or $.30 per share on a diluted basis, related to an acquisition. Our income before extraordinary item in 2004 was $26.2 million, an increase of 43.0% over net income reported in 2003. Our earnings per share were impacted by an increase in the weighted average number of shares from 13.2 million for 2003 to 18.1 million for 2004. This increase was primarily attributable to our offering of 4.6 million shares of Class A common stock that was completed in December 2003.

**Book Value Per Share and Return on Equity**

Our stockholders' equity increased by $34.1 million in 2004, primarily as a result of favorable operating results. Book value per share increased by 10.7% to $13.53 at December 31, 2004, compared to $12.22 a year earlier. Our return on average equity was 14.0% in 2004, compared to 12.2% in 2003.

**Financial Condition**

**Liquidity and Capital Resources**

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

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement with the Mutual Company historically has been cash flow positive because of the historical underwriting profitability of the pool. The pool is settled monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. We have not experienced any unusual variations in the timing of claim payments associated with our loss reserves. We maintain a high degree of liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. Our fixed-maturity investment portfolio is structured following a "laddering" approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations should an unexpected variation occur in the future. Net cash flows provided by operating activities in 2005, 2004 and 2003, were $48.9 million, $34.0 million and $31.0 million, respectively.

On May 24, 2004, we received $5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2005, the interest rate on the debentures was 8.24%.

On December 1, 2003, we completed an underwritten public offering of 4.6 million shares of our Class A common stock, resulting in net proceeds of $59.0 million to us.

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year $35.0 million unsecured, revolving line of credit. As of December 31, 2005, we may borrow up to $35.0 million at interest rates equal to M&T's current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our subsidiaries. As of December 31, 2005, there were no borrowings outstanding, and we complied with all requirements of the agreement.

On October 29, 2003, we received $10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2005, the interest rate on the debentures was 8.09%.

On May 15, 2003, we received $15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At December 31, 2005, the interest rate on the debentures was 8.43%.

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

The following table shows our expected payments for significant contractual obligations as of December 31, 2005.

| (in thousands) | Total | Less than 1 year | 1-3 years | 4-5 years | After 5 years |
|---|---|---|---|---|---|
| Net liability for unpaid losses and loss expenses | $ 173,009 | $ 77,321 | $ 79,412 | $ 7,913 | $ 8,363 |
| Subordinated debentures | 30,929 | — | — | — | 30,929 |
| Total contractual obligations | $ 203,938 | $ 77,321 | $ 79,412 | $ 7,913 | $ 39,292 |

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

Dividends declared to stockholders totaled $7.0 million, $6.2 million and $4.4 million in 2005, 2004 and 2003, respectively. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2005, our insurance subsidiaries' capital were each substantially above the RBC requirements. In 2006, amounts available for distribution as dividends to us without prior approval of their domiciliary insurance regulatory authorities are $21.9 million from Atlantic States, $2.1 million from Le Mars, $2.9 million from Peninsula and $5.4 million from Southern.

As of January 1, 2004, we acquired all of the outstanding capital stock of Le Mars, the successor to Le Mars Mutual Insurance Company of Iowa following its conversion to a stock insurance company pursuant to a plan of conversion. We acquired the capital stock of Le Mars for approximately $12.9 million in cash, including payment of $4.4 million to the Mutual Company for a surplus note that the Mutual Company had infused into Le Mars and accrued interest.

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

As of January 1, 2004, we acquired all of the outstanding common stock of Peninsula from Folksamerica Holding Company, Inc. pursuant to a stock purchase agreement. The cash purchase price of approximately $23.5 million was equal to 107.5% of the consolidated GAAP stockholders' equity of Peninsula as of the date of closing of the acquisition.

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

On February 17, 2005, our Board of Directors approved a four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33 1/3% stock dividend to stockholders of record at the close of business March 1, 2005 and paid on March 28, 2005. The capital stock accounts, all share amounts and earnings per share amounts for 2004 and prior years have been restated to reflect this stock split.

**Investments**

At December 31, 2005 and 2004, our investment portfolio of investment-grade bonds, common stock, preferred stock, short-term investments and cash totaled $551.6 million and $506.4 million, respectively, representing 70.6% and 68.9%, respectively, of our total assets.

At December 31, 2005 and 2004, the carrying value of our fixed maturity investments represented 86.8% and 82.0% of our total invested assets, respectively.

Our fixed-maturity investments consisted of high-quality marketable bonds, all of which were rated at investment-grade levels, at December 31, 2005 and 2004. As we invested excess cash from operations and proceeds from maturities of fixed-maturity investments during 2005, we increased our holdings of tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

At December 31, 2005, the net unrealized gain on available-for-sale fixed maturities, net of deferred taxes, amounted to $0, compared to $3.0 million at December 31, 2004.

At December 31, 2005, the net unrealized gain on our equity securities, net of deferred taxes, amounted to $2.5 million, compared to $1.7 million at December 31, 2004.

**Quantitative and Qualitative Disclosures About Market Risk**

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

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

**Interest Rate Risk**

Our exposure to market risk for a change in interest rates is concentrated in our investment portfolio. We monitor this exposure through periodic reviews of asset and liability positions. Estimates of cash flows and the impact of interest rate fluctuations relating to the investment portfolio are monitored

regularly. Generally, we do not hedge our exposure to interest rate risk because we have the capacity to, and do, hold fixed maturity investments to maturity.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 2005 are as follows:

| (in thousands) | Principal Cash Flows | Weighted-Average Interest Rate |
|---|---|---|
| Fixed maturities and short-term bonds: | | |
| 2006 | $ 55,928 | 2.20% |
| 2007 | 30,957 | 4.76 |
| 2008 | 33,399 | 4.17 |
| 2009 | 41,853 | 4.42 |
| 2010 | 28,402 | 4.62 |
| Thereafter | 304,838 | 4.76 |
| Total | $ 495,377 | |
| Market value | $ 504,352 | |
| Debt: | | |
| Thereafter | $ 30,929 | 8.28% |
| Total | $ 30,929 | |
| Fair value | $ 30,929 | |

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

**Equity Price Risk**

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

**Credit Risk**

Our objective is to earn competitive returns by investing in a diversified portfolio of securities. Our portfolio of fixed-maturity securities and, to a lesser extent, short-term investments is subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the amount that any one security can constitute of our total investment portfolio.

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

Because the pooling agreement does not relieve Atlantic States of primary liability as the originating insurer, we are subject to a concentration of credit risk arising from business ceded to the Mutual Company. Our insurance subsidiaries maintain reinsurance agreements in place with the Mutual Company and with a number of other major unaffiliated authorized reinsurers.

**Impact of Inflation**

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

**Impact of New Accounting Standards**

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R), "Share-Based Payment," a revision of SFAS No. 123 and superseding APB Opinion No. 25. SFAS No. 123(R) requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. In April 2005, the Securities and Exchange Commission delayed the effective date of SFAS No. 123(R) and stated that the provisions of SFAS No. 123(R) are now effective for annual reporting periods beginning after June 15, 2005. We are required to adopt SFAS No. 123(R) in the first quarter of 2006. Upon adoption, the pro forma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. We are evaluating the alternatives allowed under the standard, and we expect the adoption of SFAS No. 123(R) to result in amounts that are similar to the current pro forma disclosures under SFAS No. 123 for all share-based payment transactions through December 31, 2005. The impact of any future share-based payment transactions on our financial position or results of operations cannot be determined. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current rules. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. The amount of operating cash flows recognized for such excess tax deductions were $1.9 million, $2.2 million and $179,097 in 2005, 2004 and 2003, respectively.

In September 2005, the Accounting Standards Executive Committee issued SOP 05-1, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts." SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FAS 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments." SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement or rider to a contract, or by the election of a feature or coverage within a contract. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. We do not expect the impact of adopting SOP 05-1 will have a significant effect on operations, financial condition or liquidity.

Donegal Group Inc.

## Consolidated Balance Sheets

| December 31, | 2005 | 2004 |
|---|---|---|
| ***Assets*** | | |
| Investments | | |
| Fixed maturities | | |
| Held to maturity, at amortized cost (fair value $178,601,127 and $184,688,482) | $180,182,305 | $182,573,784 |
| Available for sale, at fair value (amortized cost $295,097,229 and $222,071,804) | 295,097,235 | 226,757,322 |
| Equity securities, available for sale, at fair value (cost $28,993,361 and $30,770,759) | 33,371,360 | 33,504,976 |
| Investments in affiliates | 8,441,546 | 8,864,741 |
| Short-term investments, at cost, which approximates fair value | 30,653,668 | 47,368,509 |
| Total investments | 547,746,114 | 499,069,332 |
| Cash | 3,811,011 | 7,350,330 |
| Accrued investment income | 5,521,335 | 4,961,173 |
| Premiums receivable | 47,124,106 | 44,266,681 |
| Reinsurance receivable | 94,137,096 | 98,478,657 |
| Deferred policy acquisition costs | 23,476,593 | 22,257,760 |
| Deferred tax asset, net | 11,532,834 | 10,922,440 |
| Prepaid reinsurance premiums | 40,063,138 | 35,907,376 |
| Property and equipment, net | 5,234,423 | 5,508,840 |
| Accounts receivable — securities | 411,149 | 1,383,587 |
| Federal income taxes recoverable | 901,341 | 3,468,506 |
| Other | 1,462,448 | 1,840,719 |
| Total assets | $781,421,588 | $735,415,401 |
| ***Liabilities and Stockholders' Equity*** | | |
| Liabilities | | |
| Losses and loss expenses | $265,729,527 | $267,190,060 |
| Unearned premiums | 186,660,050 | 174,458,423 |
| Accrued expenses | 12,706,485 | 13,413,518 |
| Reinsurance balances payable | 1,814,292 | 1,716,372 |
| Cash dividends declared to stockholders | 1,781,393 | 1,566,995 |
| Subordinated debentures | 30,929,000 | 30,929,000 |
| Accounts payable — securities | 896,893 | — |
| Due to affiliate | 728,486 | 240,680 |
| Drafts payable | 703,912 | 1,278,433 |
| Other | 1,575,364 | 1,917,606 |
| Total liabilities | 503,525,402 | 492,711,087 |
| Stockholders' Equity | | |
| Preferred stock, $1.00 par value, authorized 2,000,000 shares; none issued | — | — |
| Class A common stock, $.01 par value, authorized 30,000,000 shares, issued 14,367,344 and 13,859,771 shares and outstanding 14,258,646 and 13,755,351 shares | 143,673 | 138,598* |
| Class B common stock, $.01 par value, authorized 10,000,000 shares, issued 4,237,033 and 4,236,366 shares and outstanding 4,182,684 and 4,182,017 shares | 42,370 | 42,364* |
| Additional paid-in capital | 141,932,954 | 131,980,264 |
| Accumulated other comprehensive income | 2,532,073 | 4,749,965 |
| Retained earnings | 134,136,864 | 106,684,871* |
| Treasury stock, at cost | (891,748) | (891,748) |
| Total stockholders' equity | 277,896,186 | 242,704,314 |
| Total liabilities and stockholders' equity | $781,421,588 | $735,415,401 |

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

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

## Consolidated Statements of Income and Comprehensive Income

| Year Ended December 31, | 2005 | 2004 | 2003 |
|---|---|---|---|
| ***Statements of Income*** | | | |
| Revenues | | | |
| Net premiums earned (includes affiliated reinsurance of $104,228,169, $100,773,324 and $94,173,934 — see footnote 3) | $294,498,023 | $265,838,594 | $196,792,696 |
| Investment income, net of investment expenses | 18,471,963 | 15,906,728 | 13,315,936 |
| Installment payment fees | 4,123,856 | 3,686,790 | 2,464,604 |
| Lease income | 950,543 | 890,306 | 845,211 |
| Net realized investment gains | 1,802,809 | 1,466,220 | 1,368,031 |
| Other income | — | — | 205,850 |
| Total revenues | 319,847,194 | 287,788,638 | 214,992,328 |
| Expenses | | | |
| Net losses and loss expenses (includes affiliated reinsurance of $60,284,232, $55,109,122 and $53,659,974 — see footnote 3) | 167,541,897 | 164,141,368 | 126,243,311 |
| Amortization of deferred policy acquisition costs | 47,234,000 | 39,434,000 | 30,839,000 |
| Other underwriting expenses | 47,163,396 | 42,544,166 | 28,686,365 |
| Policy dividends | 1,620,606 | 1,300,893 | 1,154,773 |
| Interest | 2,266,346 | 1,613,511 | 1,287,197 |
| Other | 1,675,454 | 1,700,449 | 1,345,307 |
| Total expenses | 267,501,699 | 250,734,387 | 189,555,953 |
| Income before income tax expense and extraordinary item | 52,345,495 | 37,054,251 | 25,436,375 |
| Income tax expense | 15,395,998 | 10,885,652 | 7,142,399 |
| Income before extraordinary item | 36,949,497 | 26,168,599 | 18,293,976 |
| Extraordinary gain — unallocated negative goodwill | — | 5,445,670 | — |
| Net income | $ 36,949,497 | $ 31,614,269 | $ 18,293,976 |
| Basic earnings per common share | | | |
| Income before extraordinary item | $ 2.05 | $ 1.49* | $ 1.43* |
| Extraordinary item | — | .31* | — |
| Net income | $ 2.05 | $ 1.80* | $ 1.43* |
| Diluted earnings per common share | | | |
| Income before extraordinary item | $ 1.98 | $ 1.44* | $ 1.39* |
| Extraordinary item | — | .30* | — |
| Net income | $ 1.98 | $ 1.74* | $ 1.39* |
| ***Statements of Comprehensive Income*** | | | |
| Net income | $ 36,949,497 | $ 31,614,269 | $ 18,293,976 |
| Other comprehensive income (loss), net of tax | | | |
| Unrealized gains on securities: | | | |
| Unrealized holding gain (loss) arising during the period, net of income tax (benefit) of ($563,267), $221,920, and $754,840 | (1,046,066) | 412,085 | 1,268,190 |
| Reclassification adjustment for gains included in net income, net of income tax of $630,983, $513,177 and $478,811 | (1,171,826) | (953,043) | (889,220) |
| Other comprehensive income (loss) | (2,217,892) | (540,958) | 378,970 |
| Comprehensive income | $ 34,731,605 | $ 31,073,311 | $ 18,672,946 |

* All 2004 and 2003 per share information has been restated for a 4-for-3 stock split as discussed in footnote1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

## Consolidated Statements of Stockholders' Equity

| | Common Stock | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Class A Shares | Class B Shares | Class A Amount | Class B Amount | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Retained Earnings | Treasury Stock | Total Stockholders' Equity |
| Balance, January 1, 2003* | 8,358,259 | 4,032,768 | $ 83,583 | $40,328 | $ 60,651,751 | $ 4,911,953 | $ 68,386,983 | $(891,748) | $133,182,850 |
| Issuance of common stock | 4,729,333 | | 47,293 | | 60,193,670 | | | | 60,240,963 |
| Net income | | | | | | | 18,293,976 | | 18,293,976 |
| Cash dividends | | | | | | | (4,372,154) | | (4,372,154) |
| Exercise of stock options | 85,884 | 36,092 | 859 | 361 | 744,310 | | | | 745,530 |
| Grant of stock options | | | | | 976,077 | | (976,077) | | — |
| Tax benefit on exercise of stock options | | | | | 179,097 | | | | 179,097 |
| Other comprehensive income | | | | | | 378,970 | | | 378,970 |
| Balance, December 31, 2003* | 13,173,476 | 4,068,860 | $131,735 | $40,689 | $122,744,905 | $ 5,290,923 | $ 81,332,728 | $(891,748) | $208,649,232 |
| Issuance of common stock | 64,982 | 377 | 650 | 3 | 859,945 | | | | 860,598 |
| Net income | | | | | | | 31,614,269 | | 31,614,269 |
| Cash dividends | | | | | | | (6,174,867) | | (6,174,867) |
| Exercise of stock options | 621,313 | 167,129 | 6,213 | 1,672 | 6,081,938 | | | | 6,089,823 |
| Grant of stock options | | | | | 87,259 | | (87,259) | | — |
| Tax benefit on exercise of stock options | | | | | 2,206,217 | | | | 2,206,217 |
| Other comprehensive loss | | | | | | (540,958) | | | (540,958) |
| Balance, December 31, 2004* | 13,859,771 | 4,236,366 | $138,598 | $42,364 | $131,980,264 | $ 4,749,965 | $106,684,871 | $(891,748) | $242,704,314 |
| Issuance of common stock | 63,126 | | 631 | | 1,149.992 | | | | 1,150,623 |
| Net income | | | | | | | 36,949,497 | | 36,949,497 |
| Cash dividends | | | | | | | (7,027,541) | | (7,027,541) |
| Exercise of stock options | 444,447 | 667 | 4,444 | 6 | 4,395,808 | | | | 4,400,258 |
| Grant of stock options | | | | | 2,469,963 | | (2,469,963) | | — |
| Tax benefit on exercise of stock options | | | | | 1,936,927 | | | | 1,936,927 |
| Other comprehensive loss | | | | | | (2,217,892) | | | (2,217,892) |
| Balance, December 31, 2005 | 14,367,344 | 4,237,033 | $143,673 | $42,370 | $141,932,954 | $ 2,532,073 | $134,136,864 | $(891,748) | $277,896,186 |

* All 2004 and 2003 capital accounts and share information have been restated for a 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

## Consolidated Statements of Cash Flows

| Year Ended December 31, | 2005 | 2004 | 2003 |
|---|---|---|---|
| Cash Flows from Operating Activities: | | | |
| Net income | $ 36,949,497 | $ 31,614,269 | $ 18,293,976 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Extraordinary gain — unallocated negative goodwill | — | (5,445,670) | — |
| Depreciation and amortization | 3,066,227 | 2,472,813 | 1,532,664 |
| Net realized investment gains | (1,802,809) | (1,466,220) | (1,368,031) |
| Changes in Assets and Liabilities: | | | |
| Losses and loss expenses | (1,460,533) | 13,353,426 | 7,222,305 |
| Unearned premiums | 12,201,627 | 20,002,138 | 13,025,588 |
| Accrued expenses | (707,033) | 2,406,540 | 1,186,054 |
| Premiums receivable | (2,857,425) | (6,638,081) | (2,730,458) |
| Deferred policy acquisition costs | (1,218,833) | (6,033,995) | (1,656,695) |
| Deferred income taxes | 583,857 | (405,256) | (352,731) |
| Reinsurance receivable | 4,341,561 | (9,402,114) | 2,198,166 |
| Accrued investment income | (560,162) | (503,171) | 63,374 |
| Amounts due to/from affiliate | 487,806 | (663,772) | (3,175,963) |
| Reinsurance balances payable | 97,920 | (576,711) | 255,353 |
| Prepaid reinsurance premiums | (4,155,762) | (2,558,204) | (2,837,658) |
| Current income taxes | 4,504,092 | (1,852,097) | 137,358 |
| Other, net | (538,492) | (306,822) | (820,406) |
| Net adjustments | 11,982,041 | 2,382,804 | 12,678,920 |
| Net cash provided by operating activities | 48,931,538 | 33,997,073 | 30,972,896 |
| Cash Flows from Investing Activities: | | | |
| Purchase of fixed maturities | | | |
| Held to maturity | (9,747,396) | (64,920,048) | (51,747,067) |
| Available for sale | (144,354,178) | (75,037,253) | (104,935,346) |
| Purchase of equity securities | (21,643,113) | (20,631,815) | (16,505,807) |
| Sale of fixed maturities | | | |
| Held to maturity | 860,000 | — | 1,971,000 |
| Available for sale | 46,928,296 | 27,813,196 | 16,575,179 |
| Maturity of fixed maturities | | | |
| Held to maturity | 10,403,050 | 21,446,791 | 22,256,933 |
| Available for sale | 23,951,015 | 53,944,121 | 84,393,268 |
| Sale of equity securities | 26,329,709 | 14,924,971 | 12,457,028 |
| Purchase of Le Mars Insurance Company (net of cash acquired) | — | (11,816,523) | — |
| Purchase of Peninsula Insurance Group (net of cash acquired) | — | (21,912,629) | — |
| Net decrease (increase) in investment in affiliates | 52,781 | (2,222,872) | (4,048,000) |
| Net purchase of property and equipment | (703,600) | (521,095) | (371,477) |
| Net sales (purchases) of short-term investments | 16,714,841 | 40,259,336 | (49,314,707) |
| Net cash used in investing activities | (51,208,595) | (38,673,820) | (89,268,996) |
| Cash Flows from Financing Activities: | | | |
| Issuance of common stock | 5,550,881 | 6,948,287 | 60,974,365 |
| Issuance of subordinated debentures | — | 5,155,000 | 25,774,000 |
| Payments on line of credit | — | — | (19,800,000) |
| Cash dividends paid | (6,813,143) | (5,984,731) | (3,868,348) |
| Net cash provided by (used in) financing activities | (1,262,262) | 6,118,556 | 63,080,017 |
| Net increase (decrease) in cash | (3,539,319) | 1,441,809 | 4,783,917 |
| Cash at beginning of year | 7,350,330 | 5,908,521 | 1,124,604 |
| Cash at end of year | $ 3,811,011 | $ 7,350,330 | $ 5,908,521 |

See accompanying notes to consolidated financial statements.

## Notes to Consolidated Financial Statements

### 1 — Summary of Significant Accounting Policies

### Organization and Business

We were organized in 1986 as a downstream insurance holding company by Donegal Mutual Insurance Company (the “Mutual Company”) and operate predominantly as an underwriter of property and casualty insurance through our subsidiaries. Our property and casualty insurance subsidiaries, Atlantic States Insurance Company (“Atlantic States”), Southern Insurance Company of Virginia (“Southern”), Le Mars Insurance Company (“Le Mars”), and the Peninsula Insurance Group (“Peninsula”), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in the Mid-Atlantic, Midwest and Southern states. We have three operating segments: the investment function, the personal lines function and the commercial lines function. Our personal lines products consist primarily of homeowners and private passenger automobile policies. Our commercial lines products consist primarily of commercial automobile, commercial multi-peril and workers’ compensation policies. At December 31, 2005, the Mutual Company held approximately 42% of our outstanding Class A common stock and approximately 67% of our outstanding Class B common stock. We refer to the Mutual Company and our insurance subsidiaries as the Donegal Insurance Group.

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

We also own 48.1% of the outstanding stock of Donegal Financial Services Corporation (“DFSC”), a thrift holding company that owns Province Bank FSB. The remaining 51.9% of the outstanding stock of DFSC is owned by the Mutual Company.

On December 1, 2003, we completed an underwritten public offering of 4.6 million shares of our Class A common stock, resulting in net proceeds of $59.0 million to us.

On September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, “Shelby”), part of Vesta Insurance Group, Inc. The agreement grants those members the right, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby’s personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby’s plans of withdrawal from those three states. As part of the agreement, the Donegal Insurance Group will pay specified amounts to Shelby based on the direct premiums written by the Donegal Insurance Group on the renewal and replacement policies it issues. Renewal and replacement policies will be offered for policies issued on or after January 1, 2006. Thus, the agreement had no impact on our 2005 operating results.

### Basis of Consolidation

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

### Use of Estimates

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

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

### Reclassification

Certain amounts as reported in the Consolidated Balance Sheets, Consolidated Statements of Cash Flows and Notes to Consolidated Financial Statements in 2004 and 2003 have been reclassified to conform to the current year presentation. The capital stock accounts, all share amounts and earnings per share amounts for 2004 and 2003 have been restated to reflect the four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33 1/3% stock dividend to stockholders of record at the close of business March 1, 2005 and paid on March 28, 2005.

**Investments**

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

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

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

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

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

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

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

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

**Fair Values of Financial Instruments**

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

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

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

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

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

**Revenue Recognition**

Insurance premiums are recognized 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 underwriting costs that vary with and are directly related to the production of business, are deferred and amortized over the period in which the premiums are earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, losses and loss expenses and certain other costs expected to be incurred as the premium is earned. Estimates in the calculation of policy acquisition costs have not shown material variability because of uncertainties in applying accounting principles or as a result of sensitivities to changes in key assumptions.

**Property and Equipment**

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

**Losses and Loss Expenses**

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

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

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

stability in economic conditions and the rate of loss cost inflation. For example, we have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business, and consistency in reinsurance coverage and collectibility of reinsured losses, among other items. To the extent we determine that underlying factors impacting our assumptions have changed, we attempt to make appropriate adjustments for such changes in our reserves. Accordingly, our ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded.

We seek to enhance our underwriting results by carefully selecting the product lines we underwrite. For our personal lines products, we insure standard and preferred risks in private passenger automobile and homeowners lines. For our commercial lines products, the commercial risks that we primarily insure are mercantile risks, business offices, wholesalers, service providers, contractors and artisan risks, avoiding industrial and manufacturing exposures. We have limited exposure to asbestos and other environmental liabilities. We write no medical malpractice or professional liability risks.

**Guaranty Fund Liability Accruals**

We make estimates of our insurance subsidiaries' liabilities for guaranty fund and other assessments because of insurance company insolvencies from states in which our insurance subsidiaries are licensed. Generally, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies. We generally record our liability for such assessments as we write premiums upon which those assessments are based.

**Income Taxes**

We currently file a consolidated federal income tax return.

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

**Credit Risk**

Our objective is to earn competitive returns by investing in a diversified portfolio of securities. Our portfolio of fixed-maturity securities and, to a lesser extent, short-term investments is subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the amount that any one security can constitute of our total investment portfolio.

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

Our insurance subsidiaries have reinsurance agreements in place with the Mutual Company and with a number of other authorized reinsurers with at least an A.M. Best rating of A- or an equivalent financial condition.

**Reinsurance Accounting and Reporting**

We rely upon reinsurance agreements to limit our maximum net loss from large single risks or risks in concentrated areas, and to increase our capacity to write insurance. Reinsurance does not relieve the primary insurer from liability to its policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable under the terms of a reinsurance agreement, we are exposed to the risk of continued liability for such losses. However, in an effort to reduce the risk of non-payment, we require all of our reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition that, in the opinion of management, is equivalent to a company with at least an A- rating. All reinsurance transactions are recorded in a manner consistent with Statement of Financial Accounting Standards (SFAS) No. 113, "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts." See Note 10 — Reinsurance for more information regarding our reinsurance agreements.

**Stock-Based Compensation**

Effective July 1, 2000, we adopted Financial Accounting Standards Board (FASB) Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions involving Stock Compensation," and Emerging Issues Task Force Issue No. 00-23 (EITF 00-23), "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25, Accounting for Stock Issued to Employees and FIN No. 44, Accounting for Certain Transactions involving Stock Compensation." Pursuant to FIN No. 44, APB Opinion No. 25 does not apply in the separate financial statements of a subsidiary to the accounting for stock compensation granted by the subsidiary to employees of the parent or another subsidiary. EITF 00-23 states that when employees of a controlling entity are granted stock compensation, the entity granting the stock compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to us, because the Mutual Company is the employer of record for substantially all employees that provide services to us.

We account for stock-based director compensation plans under the provisions of APB Opinion No. 25 and related interpretations. During 2001, we adopted an Equity Incentive Plan for Directors that made 266,667 shares of Class A common stock available for issuance. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 233 shares of restricted stock to each director on the first business day of January in each year. No stock-based director compensation is reflected in income for grants of stock options, as all options granted under those plans had an exercise price equal to, or greater than, the market value of the underlying common stock on the date of the grant.

The following table illustrates the effect on net income and earnings per share as if we had applied the provisions of SFAS No. 123 (as amended by SFAS No. 148), "Accounting for Stock-Based Compensation."

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Net income, as reported | $36,949,497 | $31,614,269 | $18,293,976 |
| Less: | | | |
| Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects | (66,427) | (18,657) | (12,092) |
| Pro forma net income | $36,883,070 | $31,595,612 | $18,281,884 |
| Basic earnings per share: | | | |

| | | | |
|---|---|---|---|
| As reported | $ 2.05 | $ 1.80 | $ 1.43 |
| Pro forma | 2.04 | 1.80 | 1.43 |
| Diluted earnings per share: | | | |
| As reported | $ 1.98 | $ 1.74 | $ 1.39 |
| Pro forma | 1.98 | 1.74 | 1.39 |

The weighted-average grant date fair value of options granted during 2005 was $4.36. This fair value was calculated based upon a risk-free interest rate of 4%, expected life of 3 years, expected volatility of 30% and expected dividend yield of 2%.

The weighted-average grant date fair value of options granted during 2003 was $2.18. This fair value was calculated based upon a risk-free interest rate of 1.8%, expected life of 3 years, expected volatility of 34% and expected dividend yield of 4%.

**Earnings per Share**

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

**2 — Impact of New Accounting Standards**

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," a revision of SFAS No. 123 and superseding APB Opinion No. 25. SFAS No. 123(R) requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. In April 2005, the Securities and Exchange Commission delayed the effective date of SFAS No. 123(R) and stated that the provisions of SFAS No. 123(R) are now effective for annual reporting periods beginning after June 15, 2005. We are required to adopt SFAS No. 123(R) in the first quarter of 2006. Upon adoption, the pro forma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. We are evaluating the alternatives allowed under the standard, and we expect the adoption of SFAS No. 123(R) to result in amounts that are similar to the current pro forma disclosures under SFAS No. 123 for all share-based payment transactions through December 31, 2005. The impact of any future share-based payment transactions on our financial position or results of operations cannot be determined. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current rules. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. The amount of operating cash flows recognized for such excess tax deductions were $1.9 million, $2.2 million and $179,097 in 2005, 2004 and 2003, respectively.

In September 2005, the Accounting Standards Executive Committee issued Statement of Position (SOP) 05-1, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts." SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FAS 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments." SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, by amendment, endorsement or rider to a contract or by the election of a feature or coverage within a contract. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. We do not expect the impact of adopting SOP 05-1 will have a significant effect on our operations, financial condition or liquidity.

**3 — Transactions with Affiliates**

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

**a. Reinsurance Pooling and Other Reinsurance Arrangements**

Atlantic States, our largest subsidiary, and the Mutual Company have a pooling agreement under which both companies contribute all of their direct written business to the pool and are allocated a given percentage of the pool's combined underwriting results, excluding certain reinsurance assumed by the Mutual Company from our insurance subsidiaries and after giving effect to reinsurance transactions with other insurers or reinsurers who are not a party to the pooling agreement. Atlantic States has a 70% share of the results of the pool, and the Mutual Company has a 30% share of the results of the pool. The pooling agreement is intended to produce more uniform and stable underwriting results from year to year for each pool participant than they would experience individually and to spread the risk of loss among the participants based on each participant's relative amount of surplus and relative access to capital. Each participant in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposures of a size commensurate with its own capital and surplus.

The following amounts represent ceded reinsurance transactions related to the pooling agreement for 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Premiums earned | $72,448,322 | $62,831,701 | $55,846,128 |
| Losses and loss expenses | $42,221,699 | $42,487,082 | $35,840,578 |
| Prepaid reinsurance premiums | $38,332,137 | $34,227,955 | $29,981,597 |
| Liability for losses and loss expenses | $56,024,073 | $57,989,162 | $52,263,271 |

The following amounts represent assumed reinsurance transactions related to the pooling agreement for 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Premiums earned | $181,979,294 | $167,949,892 | $153,068,026 |
| Losses and loss expenses | $102,928,483 | $101,567,995 | $ 99,677,221 |
| Unearned premiums | $ 90,357,498 | $ 84,350,320 | $ 77,782,685 |
| Liability for losses and loss expenses | $128,428,653 | $127,127,611 | $121,297,553 |

Effective October 1, 2005, the Mutual Company entered into a quota-share reinsurance agreement with Southern whereby Southern assumes 100% of the premiums and losses related to personal lines products offered in Virginia by the Mutual Company through the use of its automated policy quoting and issuance system. The following amounts represent assumed reinsurance transactions related to the quota-share reinsurance agreement for 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Premiums earned | $ 22,392 | $ — | $ — |
| Losses and loss expenses | $ — | $ — | $ — |
| Unearned premiums | $158,729 | $ — | $ — |
| Liability for losses and loss expenses | $ — | $ — | $ — |

Effective August 1, 2005, the Mutual Company entered into a quota-share reinsurance agreement with Peninsula whereby the Mutual Company assumes 100% of the premiums and losses related to the Pennsylvania workers' compensation product line of Peninsula Indemnity Company. Prior to January 1, 2002, the Mutual Company and Southern had a quota-share agreement whereby Southern ceded 50% of its direct business, less reinsurance, to the Mutual Company. This agreement was terminated as of January 1, 2002. The business assumed by the Mutual Company becomes part of the pooling agreement between the Mutual Company and Atlantic States. The following amounts represent ceded reinsurance transactions related to the quota-share reinsurance agreements for 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Premiums earned | $ 6,576 | $ — | $ — |
| Losses and loss expenses | $ (264,275) | $ (611,479) | $ (73,077) |
| Prepaid reinsurance premiums | $ 36,475 | $ — | $ — |
| Liability for losses and loss expenses | $1,331,482 | $2,333,521 | $4,175,127 |

Atlantic States, Southern and Le Mars each have a catastrophe reinsurance agreement with the Mutual Company that limits the maximum liability under any one catastrophic occurrence to $800,000, $600,000 and $500,000, respectively, with a combined limit of $1,500,000 for a catastrophe involving a combination of these subsidiaries. The Mutual Company and Southern have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $260,000 ($170,000 in 2004 and $150,000 in 2003) of losses in excess of $200,000 ($150,000 in 2003). The Mutual Company has agreements in place with Southern to reallocate the loss results of workers' compensation business written by those companies as part of commercial accounts primarily written by the Mutual Company or Atlantic States. These agreements provide for the workers' compensation loss ratios of Southern to be no worse than the average workers' compensation loss ratio for Atlantic States, Southern and the Mutual Company combined. The following amounts represent ceded reinsurance transactions related to these reinsurance agreements for 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Premiums earned | $5,318,619 | $4,344,867 | $ 3,047,964 |
| Losses and loss expenses | $ 686,827 | $4,583,270 | $10,249,746 |
| Liability for losses and loss expenses | $5,057,471 | $7,532,812 | $ 7,218,397 |

The following amounts represent the effect of affiliated reinsurance transactions on net premiums earned during 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Assumed | $182,001,686 | $167,949,892 | $153,068,026 |
| Ceded | (77,773,517) | (67,176,568) | (58,894,092) |
| Net | $104,228,169 | $100,773,324 | $ 94,173,934 |

The following amounts represent the effect of affiliated reinsurance transactions on net losses and loss expenses during 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Assumed | $102,928,483 | $101,567,995 | $ 99,677,221 |
| Ceded | (42,644,251) | (46,458,873) | (46,017,247) |
| Net | $ 60,284,232 | $ 55,109,122 | $ 53,659,974 |

In addition to the reinsurance agreements described above, Southern and Le Mars (effective April 1, 2004) have agreements with the Mutual Company under which they cede, and then reassume back, 100% of their business net of reinsurance. The primary purpose of these agreements is to provide Southern and Le Mars with the same A.M. Best rating (currently "A") as the Mutual Company, which these subsidiaries might not achieve without these agreements in place. These agreements do not transfer insurance risk. While these subsidiaries ceded and reassumed amounts received from policyholders of $75,542,412, $64,696,278 and $46,885,317 and claims of $38,529,733, $36,269,291 and $26,497,971 under these agreements in 2005, 2004 and 2003, respectively, the amounts are not reflected in our consolidated financial statements. The aggregate liabilities ceded and reassumed under these agreements were $73,683,929 and $71,377,640 at December 31, 2005 and 2004, respectively.

**b. Expense Sharing**

The Mutual Company provides facilities, management and other services to us, and we reimburse the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of us and the Mutual Company in the pooling arrangement, and our management and the management of the Mutual Company consider this allocation to be reasonable. Charges for these services totalled $47,025,782, $40,165,744 and $33,047,769 for 2005, 2004 and 2003, respectively.

**c. Lease Agreement**

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

**d. Legal Services**

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

**e. Province Bank**

As of December 31, 2005 and 2004, we had $2,479,613 and $3,762,153, respectively, in checking accounts with Province Bank, a wholly owned subsidiary of DFSC. We earned $99,610, $32,138 and $24,972 in interest on these accounts during 2005, 2004 and 2003, respectively.

**4 — Business Combinations**

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

In June 2002, the Mutual Company consummated an affiliation with Le Mars. As part of the affiliation, the Mutual Company entered into a management agreement with and made a $4.0 million surplus note investment in Le Mars. During 2003, Le Mars' board of directors adopted a plan of conversion to convert to a stock insurance company. Following policyholder and regulatory approval of the plan of conversion, we acquired all of the outstanding stock of Le Mars as of January 1, 2004 for approximately $12.9 million in cash, including payment of the principal amount of the surplus note ($4.0 million) and accrued interest ($392,740) to the Mutual Company. The operating results of Le Mars have been included in our consolidated financial statements since January 1, 2004.

The acquisition of Le Mars enables us to conduct our insurance business in four Midwest states. Le Mars, which was organized under the laws of Iowa in 1901, operates as a property and casualty insurer in Iowa, Nebraska, Oklahoma and South Dakota. Personal lines coverages represent a majority of Le Mars' premiums written, with the balance coming from farmowners and mercantile and service businesses. Le Mars' largest lines of business are private passenger automobile liability and physical damage; its other principal lines are homeowners and commercial multi-peril. For the year ended December 31, 2003, Le Mars had net premiums earned of $17.9 million. The purchase price of Le Mars was based upon an independent valuation as of July 31, 2003. In applying GAAP purchase accounting standards as of January 1, 2004, we recognized an extraordinary gain in the amount of $5.4 million related to unallocated negative goodwill resulting from this acquisition. A substantial portion of this unallocated negative goodwill was generated by the recognition of anticipated federal income tax benefits that we expect to realize over the allowable 20-year carryover period by offsetting the net operating loss carryover obtained as part of the acquisition of Le Mars against taxable income generated by our consolidated affiliates. We have determined that a valuation allowance is required for a portion of the acquired net operating loss carryover, because federal tax laws limit the amount of such carryover that can be utilized. Other factors that generated negative goodwill included favorable operating results and increases in the market values of invested assets in the period between the valuation date and the acquisition date.

As of January 1, 2004, we purchased all of the outstanding stock of Peninsula Indemnity Company and The Peninsula Insurance Company, both of which are organized under Maryland law, with headquarters in Salisbury, Maryland, from Folksamerica Holding Company, Inc. ("Folksamerica"), a part of the White Mountains Insurance Group, Ltd., for a price in cash equal to 107.5% of Peninsula's GAAP stockholders' equity as of the closing of the acquisition, or approximately $23.5 million. The operating results of Peninsula have been included in our consolidated financial statements since January 1, 2004.

Peninsula expands our presence in existing markets, operating primarily in Maryland, Delaware and Virginia. Peninsula specializes in private passenger automobile coverages and also writes homeowners, commercial multi-peril, workers' compensation and commercial automobile coverages. For the year ended December 31, 2003, Peninsula had net premiums earned of $32.7 million. We recorded goodwill of $449,968 related to this acquisition, none of which is expected to be deductible for federal income tax purposes. Pursuant to the terms of the purchase agreement with Folksamerica, Folksamerica has guaranteed us against any deficiency in excess of $1.5 million in the loss and loss expense reserves of Peninsula as of January 1, 2004. Any such deficiency will be based on a final actuarial review of the development of such reserves to be conducted four years after January 1, 2004. The maximum obligation of Folksamerica to us under this guarantee is $4.0 million.

The following is a summary of the estimated fair values of the net assets acquired at the date of each acquisition based on purchase price allocations:

| | Le Mars | Peninsula |
|---|---|---|
| | (in thousands) | |
| Assets acquired: | | |
| Investments | $ 31,913 | $ 45,644 |
| Premiums receivable | 3,699 | 4,913 |
| Reinsurance receivable | 3,602 | 4,474 |
| Other | 5,276 | 5,720 |
| Total assets acquired | 44,490 | 60,751 |
| Liabilities assumed: | | |
| Losses and loss expenses | 16,476 | 19,447 |
| Unearned premiums | 7,734 | 12,563 |
| Other | 1,983 | 5,281 |
| Total liabilities assumed | 26,193 | 37,291 |
| Total net assets acquired | $ 18,297 | $ 23,460 |

Our consolidated financial statements for the year ended December 31, 2004 include the operations of Le Mars and Peninsula from January 1, 2004, the date of their acquisition. The following table presents our unaudited pro forma historical results for the year ended December 31, 2003 as if these purchased entities had been acquired at January 1, 2003:

| ($ in thousands, except per share data) | |
|---|---|
| Total revenues | $266,778 |
| Income before income tax expense and extraordinary item | 26,542 |
| Income tax expense | 7,530 |
| Income before extraordinary item | 19,012 |
| Basic earnings per share before extraordinary item | 1.27 |
| Diluted earnings per share before extraordinary item | 1.23 |

The above pro forma earnings per share were calculated as if the proceeds of approximately 2.3 million Class A common shares issued on December 1, 2003 (representing only those proceeds used to fund the acquisitions) were received on January 1, 2003 and as if the corresponding common shares were included in weighted average shares outstanding from that date. The pro forma results do not include the impact of an extraordinary item in the amount of approximately $5.2 million related to unallocated negative goodwill that would have resulted from the Le Mars acquisition.

The unaudited pro forma results above have been prepared for comparative purposes only and do not purport to be indicative of the results of operations that actually would have resulted had the acquisitions occurred at January 1, 2003, nor are they necessarily indicative of future operating results.

### 5 — Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2005 and 2004, are as follows:

| | 2005 | | | |
|---|---|---|---|---|
| **Held to Maturity** | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 58,735,488 | $ — | $1,869,523 | $ 56,865,965 |
| Obligations of states and political subdivisions | 84,655,911 | 1,145,476 | 338,824 | 85,462,563 |
| Corporate securities | 21,508,436 | 341,108 | 399,477 | 21,450,067 |
| Mortgage-backed securities | 15,282,470 | 25,887 | 485,825 | 14,822,532 |
| Totals | $180,182,305 | $1,512,471 | $3,093,649 | $178,601,127 |

| | 2005 | | | |
|---|---|---|---|---|
| **Available for Sale** | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 51,374,133 | $ 212,379 | $ 727,857 | $ 50,858,655 |
| Obligations of states and political subdivisions | 179,004,037 | 2,190,981 | 623,988 | 180,571,030 |
| Corporate securities | 20,328,627 | 241,579 | 458,147 | 20,112,059 |
| Mortgage-backed securities | 44,390,432 | 13,710 | 848,651 | 43,555,491 |
| Fixed maturities | 295,097,229 | 2,658,649 | 2,658,643 | 295,097,235 |
| Equity securities | 28,993,361 | 4,763,905 | 385,906 | 33,371,360 |
| Totals | $324,090,590 | $7,422,554 | $3,044,549 | $328,468,595 |

| Held to Maturity | 2004 Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 60,219,180 | $ 13,107 | $ 683,647 | $ 59,548,640 |
| Obligations of states and political subdivisions | 76,651,761 | 1,867,257 | 93,018 | 78,426,000 |
| Corporate securities | 27,149,096 | 1,138,760 | 68,856 | 28,219,000 |
| Mortgage-backed securities | 18,553,747 | 159,462 | 218,367 | 18,494,842 |
| Totals | $182,573,784 | $3,178,586 | $1,063,888 | $184,688,482 |

| Available for Sale | 2004 Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 74,843,822 | $ 459,249 | $ 386,261 | $ 74,916,810 |
| Obligations of states and political subdivisions | 108,777,575 | 3,682,063 | 13,538 | 112,446,100 |
| Corporate securities | 30,378,728 | 1,063,247 | 89,925 | 31,352,050 |
| Mortgage-backed securities | 8,071,679 | 22,937 | 52,254 | 8,042,362 |
| Fixed maturities | 222,071,804 | 5,227,496 | 541,978 | 226,757,322 |
| Equity securities | 30,770,759 | 3,331,747 | 597,530 | 33,504,976 |
| Totals | $252,842,563 | $8,559,243 | $1,139,508 | $260,262,298 |

The amortized cost and estimated fair value of fixed maturities at December 31, 2005, 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 | $ 7,260,454 | $ 7,206,281 |
| Due after one year through five years | 69,024,386 | 67,352,944 |
| Due after five years through ten years | 27,600,418 | 27,848,545 |
| Due after ten years | 61,014,577 | 61,370,825 |
| Mortgage-backed securities | 15,282,470 | 14,822,532 |
| Total held to maturity | $180,182,305 | $178,601,127 |
| **Available for sale** | | |
| Due in one year or less | $ 17,906,067 | $ 17,802,962 |
| Due after one year through five years | 50,945,588 | 50,832,558 |
| Due after five years through ten years | 108,369,339 | 108,743,994 |
| Due after ten years | 73,485,803 | 74,162,230 |
| Mortgage-backed securities | 44,390,432 | 43,555,491 |
| Total available for sale | $295,097,229 | $295,097,235 |

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2005 and 2004 amounted to $9,043,786 and $8,566,784, respectively.

Investments in affiliates consisted of the following at December 31, 2005 and 2004:

| | 2005 | 2004 |
|---|---|---|
| DFSC | $7,512,546 | $7,935,741 |
| Other | 929,000 | 929,000 |
| Total | $8,441,546 | $8,864,741 |

We made additional equity investments in DFSC in the amount of $2,250,000 during 2004. Other expenses in our consolidated statements of income include $52,781, $182,128 and $226,000 for 2005, 2004 and 2003, respectively, representing our share of DFSC losses. In addition, other comprehensive income (loss) in our statements of comprehensive income includes net unrealized losses, net of tax, of $240,769, $62,366 and $50,439 for 2005, 2004 and 2003, respectively, representing our share of DFSC unrealized investment losses.

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

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Fixed maturities | $18,574,964 | $16,540,611 | $13,255,492 |
| Equity securities | 975,420 | 989,966 | 834,578 |
| Short-term investments | 966,416 | 524,172 | 523,527 |
| Other | 34,853 | 30,770 | 29,250 |
| Investment income | 20,551,653 | 18,085,519 | 14,642,847 |
| Investment expenses | (2,079,690) | (2,178,791) | (1,326,911) |
| Net investment income | $18,471,963 | $15,906,728 | $13,315,936 |

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Gross realized gains: | | | |
| Fixed maturities | $ 674,585 | $ 458,389 | $1,002,461 |
| Equity securities | 2,970,215 | 1,252,075 | 637,856 |
| | 3,644,800 | 1,710,464 | 1,640,317 |
| Gross realized losses: | | | |
| Fixed maturities | 805,183 | 35,952 | 33,759 |
| Equity securities | 1,036,808 | 208,292 | 238,527 |
| | 1,841,991 | 244,244 | 272,286 |
| Net realized gains | $ 1,802,809 | $ 1,466,220 | $1,368,031 |
| Change in difference between fair value and cost of investments: | | | |
| Fixed maturities | $(8,381,388) | $(2,617,967) | $ (901,290) |
| Equity securities | 1,643,782 | 914,179 | 1,544,745 |
| | $(6,737,606) | $(1,703,788) | $ 653,455 |

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2005 as follows:

| | Less than 12 months | | 12 months or longer | |
|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 32,943,116 | $ 641,545 | $62,590,126 | $1,955,835 |
| Obligations of states and political subdivisions | 73,457,810 | 906,530 | 6,586,927 | 56,282 |
| Corporate securities | 11,090,482 | 475,516 | 5,864,581 | 382,108 |
| Mortgage-backed securities | 36,270,000 | 785,018 | 13,836,649 | 549,458 |
| Equity securities | 3,715,877 | 240,474 | 1,178,209 | 145,432 |
| Totals | $157,477,285 | $3,049,083 | $90,056,492 | $3,089,115 |

The unrealized losses in our fixed maturities, substantially all of which are rated investment grade, were primarily due to the impact of higher market interest rates rather than a decline in credit quality. There were $88.9 million in fixed maturity securities and $1.2 million in equity securities, at fair value, that at December 31, 2005, were in an unrealized loss position for 12 months or longer. The fixed maturities and equity securities with unrealized losses have not been significantly below cost for continuous amounts of time, and we determined that the unrealized losses are temporary in nature based upon the factors we consider in determining possible impairment.

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2004 as follows:

| | Less than 12 months | | 12 months or longer | |
|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 80,588,500 | $ 940,084 | $5,370,000 | $129,824 |
| Obligations of states and political subdivisions | 13,056,950 | 106,506 | 5,000 | 50 |
| Corporate securities | 12,433,300 | 158,781 | — | — |
| Mortgage-backed securities | 15,734,625 | 151,952 | 3,584,117 | 118,669 |
| Equity securities | 5,947,354 | 540,030 | 292,500 | 57,500 |
| Totals | $127,760,729 | $1,897,353 | $9,251,617 | $306,043 |

During 2005, 2004 and 2003, certain investments trading below cost had declined on an other than temporary basis. Losses of $409,432, $6,650 and $237,724 were included in net realized investment gains for these investments in 2005, 2004 and 2003, respectively.

During 2005, we sold bonds that had been classified as held to maturity due to significant deterioration in the issuer's creditworthiness. These bonds had an amortized cost of $1.0 million, and the sale resulted in a realized loss of $144,047. During 2003, we sold certain bonds that had been classified as held to maturity due to a series of rating agency downgrades related to these securities. These bonds had an amortized cost of $1.8 million, and the sale resulted in a realized gain of $165,564. There were no other sales or transfers from the held to maturity portfolio in 2005, 2004 or 2003.

We have no derivative instruments or hedging activities.

### 6 — Deferred Policy Acquisition Costs

Changes in deferred policy acquisition costs are as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Balance, January 1 | $ 22,257,760 | $ 16,223,765 | $ 14,567,070 |
| Acquisition costs deferred | 48,452,833 | 45,467,995 | 32,495,695 |
| Amortization charged to earnings | (47,234,000) | (39,434,000) | (30,839,000) |
| Balance, December 31 | $ 23,476,593 | $ 22,257,760 | $ 16,223,765 |

### 7 — Property and Equipment

Property and equipment at December 31, 2005 and 2004 consisted of the following:

| | 2005 | 2004 | Estimated Useful Life |
|---|---|---|---|
| Office equipment | $ 6,483,921 | $ 6,135,142 | 5-15 years |
| Automobiles | 1,216,085 | 1,101,055 | 3 years |
| Real estate | 3,893,293 | 3,848,772 | 15-50 years |
| Software | 573,672 | 544,086 | 5 years |
| | 12,166,971 | 11,629,055 | |
| Accumulated depreciation | (6,932,548) | (6,120,215) | |
| | $ 5,234,423 | $ 5,508,840 | |

Depreciation expense for 2005, 2004 and 2003 amounted to $984,946, $932,987 and $650,200, respectively.

### 8 — Liability for Losses and Loss Expenses

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Balance at January 1 | $267,190,060 | $217,914,057 | $ 210,691,752 |
| Less reinsurance recoverable | (95,759,493) | (79,017,987) | (79,583,319) |
| Net balance at January 1 | 171,430,567 | 138,896,070 | 131,108,433 |
| Acquisitions of Le Mars and Peninsula | — | 28,843,140 | — |
| Net balance at January 1 as adjusted | 171,430,567 | 167,739,210 | 131,108,433 |
| Incurred related to: | | | |
| Current year | 176,924,029 | 171,384,964 | 126,693,421 |
| Prior years | (9,382,132) | (7,243,596) | (450,110) |
| Total incurred | 167,541,987 | 164,141,368 | 126,243,311 |
| Paid related to: | | | |
| Current year | 98,734,594 | 96,041,306 | 72,187,103 |
| Prior years | 67,228,986 | 64,408,705 | 46,268,571 |
| Total paid | 165,963,580 | 160,450,011 | 118,455,674 |
| Net balance at December 31 | 173,008,884 | 171,430,567 | 138,896,070 |
| Plus reinsurance recoverable | 92,720,643 | 95,759,493 | 79,017,987 |
| Balance at December 31 | $265,729,527 | $267,190,060 | $217,914,057 |

We recognized a decrease in the liability for losses and loss expenses of prior years of $9.4 million, $7.2 million and $450,110 in 2005, 2004 and 2003, respectively. Generally, we experienced improving loss development trends during these years, which were reflected in favorable settlements of open claims. We made no significant changes in our reserving philosophy, key reserving assumptions or claims management during these years, even though we reflected changes in our reserve estimates in these years. No significant offsetting changes in estimates increased or decreased our loss and loss expense reserves in these years. The 2005 development was primarily recognized in the private passenger automobile liability, workers' compensation and commercial multi-peril lines of business and was consistently favorable for settlements of claims occurring in each of the previous five accident years. The majority of the 2005 development was related to decreases in the liability for losses and loss expenses of prior years for Atlantic States. The 2004 development included decreases in the liability for losses and loss expenses of prior years for Le Mars and Peninsula of $3.6 million and $1.4 million, respectively, largely due to favorable settlement of open claims in the private passenger automobile liability line of business.

**9 — Borrowings**

**Line of Credit**

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year $35.0 million unsecured, revolving line of credit. As of December 31, 2005, we may borrow up to $35.0 million at interest rates equal to M&T's current prime rate or the then current London Interbank Eurodollar bank rate (LIBOR) plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. During the year ended December 31, 2005, borrowings were outstanding, and we complied with all requirements of the agreement.

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

**Subordinated Debentures**

On May 15, 2003, we received $15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At December 31, 2005, the interest rate on these debentures was 8.43%, and is next subject to adjustment on February 15, 2006. As of December 31, 2005 and 2004, our consolidated balance sheets included an investment in a trust of $464,000 and subordinated debentures of $15.5 million related to this transaction.

On October 29, 2003, we received $10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2005, the interest rate on these debentures was 8.09%, and is next subject to adjustment on January 29, 2006. As of December 31, 2005 and 2004, our consolidated balance sheets included an investment in a trust of $310,000 and subordinated debentures of $10.3 million related to this transaction.

On May 24, 2004, we received $5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2005, the interest rate on these debentures was 8.24%, and is next subject to adjustment on February 24, 2006. As of December 31, 2005 and 2004, our consolidated balance sheets included an investment in a trust of $155,000 and subordinated debentures of $5.2 million related to this transaction.

**10 — Reinsurance**

**Unaffiliated Reinsurers**

Atlantic States, Southern and the Mutual Company purchase third-party reinsurance on a combined basis. Le Mars and Peninsula have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. We use several different reinsurers, all of which, consistent with our requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating. The external reinsurance Atlantic States, Southern and the Mutual Company purchase includes "excess of loss reinsurance," under which our losses are automatically reinsured, through a series of contracts, over a set retention ($400,000 and $300,000 retention for 2005 and 2004, respectively, with us having a 10% participation for losses up to $1.0 million and $300,000 for 2003), and "catastrophic reinsurance," under which we recover, through a series of contracts, between 95% and 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention ($3.0 million). Our principal third party reinsurance

agreement was a multi-line per risk excess of loss treaty that provided 90% coverage up to $1.0 million for both property and liability losses. For property insurance, we also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $2.5 million per loss. For liability insurance, we

had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $40.0 million per occurrence. For workers' compensation insurance, we had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $5.0 million on any one life. We had property catastrophe coverage through a series of layered treaties up to aggregate losses of $80.0 million for Atlantic States, Southern and the Mutual Company for any single event. This coverage was provided through as many as twenty reinsurers on any one treaty with no reinsurer taking more than 20% of any one contract. The amount of coverage provided under each of these types of reinsurance depended upon the amount, nature, size and location of the risks being reinsured. The Mutual Company and we also purchased facultative reinsurance to cover exposures from losses that exceeded the limits provided by our respective treaty reinsurance. The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers for 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Premiums written | $19,655,767 | $22,016,464 | $10,908,851 |
| Premiums earned | $19,604,187 | $23,704,363 | $11,535,468 |
| Losses and loss expenses | $ 9,886,287 | $14,324,616 | $10,646,851 |
| Prepaid reinsurance premiums | $ 1,731,001 | $ 1,679,421 | $ 710,057 |
| Liability for losses and loss expenses | $31,176,231 | $27,903,998 | $15,361,192 |

**Total Reinsurance**

The following amounts represent the total of all ceded reinsurance transactions with both affiliated and unaffiliated reinsurers for 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Premiums earned | $97,377,704 | $90,880,931 | $70,429,560 |
| Losses and loss expenses | $52,530,538 | $60,783,489 | $56,664,098 |
| Prepaid reinsurance premiums | $40,063,138 | $35,907,376 | $30,691,654 |
| Liability for losses and loss expenses | $93,589,257 | $95,759,493 | $79,017,987 |

The following amounts represent the effect of reinsurance on premiums written during 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Direct | $ 215,719,476 | $202,064,323 | $118,605,732 |
| Assumed | 188,357,878 | 174,657,504 | 161,642,112 |
| Ceded | (101,533,466) | (93,439,390) | (73,267,218) |
| Net premiums written | $ 302,543,888 | $283,282,437 | $206,980,626 |

The following amounts represent the effect of reinsurance on premiums earned during 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Direct | $209,693,968 | $188,665,453 | $114,154,202 |
| Assumed | 182,181,759 | 168,054,072 | 153,068,054 |
| Ceded | (97,377,704) | (90,880,931) | (70,429,560) |
| Net premiums earned | $294,498,023 | $265,838,594 | $196,792,696 |

**11 — Income Taxes**

The provision for income tax consists of the following:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Current | $14,812,141 | $11,290,908 | $7,495,130 |
| Deferred | 583,857 | (405,256) | (352,731) |
| Federal tax provision | $15,395,998 | $10,885,652 | $7,142,399 |

The effective tax rate is different from the amount computed at the statutory federal rate of 35% for 2005, 2004 and 2003. The reasons for such difference and the related tax effects are as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Income before income taxes | $52,345,495 | $37,054,251 | $25,436,375 |
| Computed "expected" taxes | 18,320,923 | 12,968,988 | 8,902,731 |
| Tax-exempt interest | (3,350,307) | (2,302,247) | (1,824,830) |
| Dividends received deduction | (98,203) | (106,836) | (49,147) |
| Other, net | 523,585 | 325,747 | 113,645 |
| Federal income tax provision | $15,395,998 | $10,885,652 | $ 7,142,399 |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2005 and 2004 are as follows:

| | 2005 | 2004 |
|---|---|---|
| Deferred tax assets: | | |
| Unearned premium | $10,270,793 | $ 9,708,475 |
| Loss reserves | 6,551,470 | 6,916,375 |
| Net operating loss carryforward — acquired companies | 4,376,784 | 4,824,300 |
| Other | 1,178,323 | 1,119,355 |
| Total gross deferred assets | 22,377,370 | 22,568,505 |
| Less valuation allowance | (770,799) | (770,799) |

| | | |
|---|---|---|
| Net deferred tax assets | 21,606,571 | 21,797,706 |
| Deferred tax liabilities: | | |
| Depreciation expense | 280,477 | 316,035 |
| Deferred policy acquisition costs | 8,216,807 | 7,790,216 |
| Salvage recoverable | 213,031 | 211,342 |
| Net unrealized gains | 1,363,422 | 2,557,673 |
| Total gross deferred liabilities | 10,073,737 | 10,875,266 |
| Net deferred tax asset | $11,532,834 | $10,922,440 |

A valuation allowance is provided when it is more likely than not that some portion of the tax asset will not be realized. Management has determined that a valuation allowance of $770,799 related to a portion of the net operating loss carryforward of Le Mars should be established at December 31, 2005 and 2004. Management has determined that it is not required to establish a valuation allowance for the other net deferred tax assets of $21,606,571 and $21,797,706 at December 31, 2005 and 2004, respectively, since it is more likely than not that the deferred tax assets will be realized through reversals of existing temporary differences, future taxable income, carrybacks to taxable income in prior years and the implementation of tax-planning strategies.

At December 31, 2005, we have a net operating loss carryforward of $11.7 million which is available to offset our taxable income. Of this amount, $9.3 million will begin to expire in 2009 and is subject to an annual limitation in the amount that we can use in any one year of approximately $376,000. The remaining $2.4 million will expire in 2012 and is subject to an annual limitation of approximately $903,000.

## 12 — Stockholders' Equity

On April 19, 2001, our stockholders approved an amendment to our Certificate of Incorporation. Among other things, the amendment reclassified our common stock as Class B common stock and effected a one-for-three reverse split of our Class B common stock effective April 19, 2001. The amendment also authorized a new class of common stock with one-tenth of a vote per share designated as Class A common stock. Our Board of Directors also approved a dividend of two shares of Class A common stock for each share of Class B common stock, after the one-for-three reverse split, held of record at the close of business on April 19, 2001.

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

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

## 13 — Stock Compensation Plans

### Equity Incentive Plans

During 1996, we adopted an Equity Incentive Plan for Employees. During 2001, we adopted a nearly identical plan that made a total of 2,000,000 shares of Class A common stock available for issuance. During 2005, an amendment to the plan made a total of 3,000,000 shares of Class A common stock available for issuance. Each plan provides for the granting of awards by the Board of Directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. The plans provide that stock options may become exercisable up to 10 years from date of grant, with an option price not less than fair market value on date of grant. No stock appreciation rights or restricted stock have been issued.

During 1996, we adopted an Equity Incentive Plan for Directors. During 2001, we adopted a nearly identical plan that made 266,667 shares of Class A common stock available for issuance. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 233 shares of restricted stock to each director on the first business day of January in each year. As of December 31, 2005, we have 108,168 unexercised options under these plans. Additionally 2,800, 2,567 and 2,567 shares of restricted stock were issued on January 2, 2005, 2004 and 2003, respectively.

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

Information regarding activity in our stock option plans follows:

| | Number of Options | Weighted-Average Exercise Price Per Share |
|---|---|---|
| Outstanding at December 31, 2002 | 1,858,675 | $10.07 |
| Granted — 2003 | 890,000 | 9.00 |
| Exercised — 2003 | (121,976) | 6.11 |
| Forfeited — 2003 | (18,667) | 7.93 |
| Expired — 2003 | (635,556) | 13.50 |
| Outstanding at December 31, 2003 | 1,972,476 | 8.79 |
| Granted — 2004 | 46,000 | 14.13 |
| Exercised — 2004 | (788,442) | 7.73 |
| Forfeited — 2004 | (39,784) | 8.88 |
| Outstanding at December 31, 2004 | 1,190,250 | 9.70 |
| Granted — 2005 | 1,003,667 | 20.97 |
| Exercised — 2005 | (445,114) | 9.89 |
| Forfeited — 2005 | (37,223) | 20.69 |
| Outstanding at December 31, 2005 | 1,711,580 | $16.03 |
| Exercisable at: | | |
| December 31, 2003 | 1,178,276 | $ 8.33 |
| December 31, 2004 | 911,225 | $ 9.73 |
| December 31, 2005 | 735,802 | $ 9.51 |

Options available for future grants at December 31, 2005 are 808,599.

The following table summarizes information about fixed stock options at December 31, 2005:

| Exercise Price | Number of Options Outstanding | Weighted-Average Remaining Contractual Life | Number of Options Exercisable |
|---|---|---|---|
| $ 9.00 | 569,611 | 2.5 years | 569,611 |
| 10.50 | 143,968 | 0.5 years | 143,968 |
| 13.69 | 6,667 | 2.5 years | 4,445 |
| 15.69 | 2,667 | 3.5 years | 889 |
| 16.51 | 10,667 | 5.0 years | 3,555 |
| 16.54 | 10,000 | 4.5 years | 6,667 |
| 17.88 | 10,000 | 4.0 years | 6,667 |
| 20.33 | 10,000 | 4.5 years | — |
| 21.00 | 938,000 | 5.5 years | — |
| 23.60 | 10,000 | 5.5 years | — |
| Total | 1,711,580 | | 735,802 |

**Employee Stock Purchase Plans**

During 1996, we adopted an Employee Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 400,000 shares of Class A common stock available for issuance.

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

| | Shares Issued | |
|---|---|---|
| | Price | Shares |
| January 1, 2003 | $ 6.8531 | 12,567 |
| July 1, 2003 | 7.6181 | 11,701 |
| January 1, 2004 | 8.5871 | 10,183 |
| July 1, 2004 | 12.7564 | 6,679 |
| January 1, 2005 | 13.1899 | 8,091 |
| July 1, 2005 | 13.7063 | 8,584 |

On January 1, 2006, we issued an additional 8,072 shares at a price of $15.691 per share under this plan.

**Agency Stock Purchase Plans**

During 1996, we adopted an Agency Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 400,000 shares of Class A common stock available for issuance. The plan provides for agents of our affiliated companies to invest up to $12,000 per subscription period (April 1 to September 30 and October 1 to March 31) under various methods. Stock is issued at the end of the subscription period at a price equal to 90% of the average market price during the last ten trading days of the subscription period. During 2005, 2004 and 2003, 43,651, 43,762 and 38,063 shares, respectively, were issued under this plan. Expense recognized under the plan was not material.

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

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| **Atlantic States** | | | |
| Statutory capital and surplus | $148,521,462 | $127,219,109 | $109,854,398 |
| Statutory unassigned surplus | $ 94,860,598 | $ 73,558,245 | $ 56,193,534 |
| Statutory net income | $ 21,855,006 | $ 16,342,671 | $ 13,272,651 |
| **Southern** | | | |
| Statutory capital and surplus | $ 56,802,771 | $ 50,253,802 | $ 40,649,495 |
| Statutory unassigned surplus (deficit) | $ 7,685,185 | $ 1,136,217 | $ (1,968,090) |
| Statutory net income | $ 5,444,954 | $ 2,868,102 | $ 5,275,909 |
| **Le Mars** | | | |
| Statutory capital and surplus | $ 21,386,553 | $ 17,103,902 | $ 11,987,214 |
| Statutory unassigned surplus | $ 8,793,813 | $ 4,511,162 | $ 7,987,214 |
| Statutory net income (loss) | $ 4,293,555 | $ 3,268,819 | $ (728,329) |
| **Peninsula** | | | |
| Statutory capital and surplus | $ 29,050,474 | $ 23,176,096 | $ 19,477,027 |
| Statutory unassigned surplus | $ 11,251,060 | $ 5,576,682 | $ 3,125,533 |
| Statutory net income | $ 6,165,498 | $ 3,781,849 | $ 1,513,794 |

Our principal source of cash for payment of dividends is dividends from our insurance subsidiaries. Our insurance subsidiaries are required by law to maintain certain minimum capital and surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are also subject to Risk Based Capital (RBC) requirements that may further impact their ability to pay dividends. At December 31, 2005, the statutory capital and surplus were substantially above the RBC requirements. Amounts available for distribution as dividends to us without prior approval of insurance regulatory authorities in 2006 are $21,855,006 from Atlantic States, $5,444,954 from Southern, $2,138,655 from Le Mars and $2,905,047 from Peninsula.

**15 — Reconciliation of Statutory Filings to Amounts Reported Herein**

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

Reconciliations of 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, | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| Statutory net income of insurance subsidiaries | $37,759,013 | $26,261,441 | $18,548,560 |
| Adjustments: | | | |
| Deferred policy acquisition costs | 1,218,833 | 6,033,995 | 1,656,695 |
| Deferred federal income taxes | (583,857) | 405,256 | 352,731 |
| Salvage and subrogation recoverable | 164,306 | (112,182) | (167,627) |
| Consolidating eliminations and adjustments | (1,805,579) | (579,343) | (8,099,197) |
| Parent-only net income (loss) | 196,781 | (394,898) | 6,002,814 |
| Net income as reported herein | $36,949,497 | $31,614,269 | $18,293,976 |

| | December 31, | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |

| | | | |
|---|---|---|---|
| Statutory capital and surplus of insurance subsidiaries | $255,761,260 | $217,752,909 | $150,503,893 |
| Adjustments: | | | |
| Deferred policy acquisition costs | 23,476,593 | 22,257,760 | 16,223,765 |
| Deferred federal income taxes | (3,751,776) | (3,855,261) | (4,268,453) |
| Salvage and subrogation recoverable | 8,311,000 | 8,146,694 | 7,167,008 |
| Non-admitted assets and other adjustments, net | 837,567 | 1,121,225 | 907,955 |
| Fixed maturities | 694,311 | 6,207,157 | 6,521,246 |
| Parent-only equity and other adjustments | (7,432,769) | (8,926,170) | 31,593,818 |
| Stockholders' equity as reported herein | $277,896,186 | $242,704,314 | $208,649,232 |

## 16 — Supplementary Cash Flow Information

The following reflects income taxes and interest paid during 2005, 2004 and 2003:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Income taxes | $10,275,000 | $12,905,000 | $7,356,674 |
| Interest | $ 2,191,125 | $ 1,528,655 | $1,291,992 |

## 17 — Earnings Per Share

The following information illustrates the computation of net income, outstanding shares and earnings per share on both a basic and diluted basis for the years ended December 31, 2005, 2004 and 2003:

| | Net Income | Weighted-Average Shares Outstanding | Earnings Per Share |
|---|---|---|---|
| **2005:** | | | |
| Basic | $36,949,497 | 18,044,049 | $2.05 |
| Effect of stock options | — | 581,136 | (.07) |
| Diluted | $36,949,497 | 18,625,185 | $1.98 |
| **2004:** | | | |
| Basic | $31,614,269 | 17,545,913 | $1.80 |
| Effect of stock options | — | 634,316 | (.06) |
| Diluted | $31,614,269 | 18,180,229 | $1.74 |
| **2003:** | | | |
| Basic | $18,293,976 | 12,761,162 | $1.43 |
| Effect of stock options | — | 431,963 | (.04) |
| Diluted | $18,293,976 | 13,193,125 | $1.39 |

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

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Options excluded from diluted earnings per share | — | 10,000 | — |

## 18 — Condensed Financial Information of Parent Company

***Condensed Balance Sheets***

(in thousands)

| December 31, | 2005 | 2004 |
|---|---|---|
| ***Assets*** | | |
| Fixed-maturity investments | $ 4,192 | $ 4,120 |
| Investment in subsidiaries/affiliates (equity method) | 294,333 | 259,898 |
| Short-term investments | 9,431 | 5,585 |
| Cash | 938 | 1,581 |
| Property and equipment | 1,168 | 1,293 |
| Other | 1,110 | 3,226 |
| Total assets | $311,172 | $275,703 |
| ***Liabilities and Stockholders' Equity*** | | |
| Liabilities | | |
| Cash dividends declared to stockholders | $ 1,781 | $ 1,567 |
| Subordinated debentures | 30,929 | 30,929 |
| Other | 566 | 503 |
| Total liabilities | 33,276 | 32,999 |
| Stockholders' equity | 277,896 | 242,704 |
| Total liabilities and stockholders' equity | $311,172 | $275,703 |

***Condensed Statements of Income and Comprehensive Income***

(in thousands)

| Year Ended December 31, | 2005 | 2004 | 2003 |
|---|---|---|---|
| ***Statements of Income*** | | | |
| Revenues | | | |
| Dividends from subsidiaries | $ 2,000 | $ 950 | $ 7,000 |
| Other | 1,276 | 1,242 | 1,034 |
| Total revenues | 3,276 | 2,192 | 8,034 |
| Expenses | | | |
| Operating expenses | 1,675 | 1,700 | 1,345 |

| | | | |
|---|---|---|---|
| Interest | 2,267 | 1,614 | 1,320 |
| Total expenses | 3,942 | 3,314 | 2,665 |
| Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries | (666) | (1,122) | 5,369 |
| Income tax benefit | (862) | (727) | (634) |
| Income (loss) before equity in undistributed net income of subsidiaries | 196 | (395) | 6,003 |
| Equity in undistributed net income of subsidiaries | 36,753 | 32,009 | 12,291 |
| Net income | $36,949 | $31,614 | $18,294 |

| ***Statements of Comprehensive Income*** | | | |
|---|---|---|---|
| Net income | $36,949 | $31,614 | $18,294 |
| Other comprehensive income (loss), net of tax | | | |
| Unrealized loss — parent | (25) | (2) | (42) |
| Unrealized gain (loss) — subsidiaries | (2,192) | (539) | 421 |
| Other comprehensive income (loss), net of tax | (2,217) | (541) | 379 |
| Comprehensive income | $34,732 | $31,073 | $18,673 |

***Condensed Statements of Cash Flows***

(in thousands)

| Year Ended December 31, | 2005 | 2004 | 2003 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $ 36,949 | $ 31,614 | $ 18,294 |
| Adjustments: | | | |
| Equity in undistributed net income of subsidiaries | (36,753) | (32,009) | (12,291) |
| Other | 4,446 | 731 | (4,137) |
| Net adjustments | (32,307) | (31,278) | (16,428) |
| Net cash provided | 4,642 | 336 | 1,866 |
| Cash flows from investing activities: | | | |
| Net purchase of fixed maturities | — | (2,084) | (1,938) |
| Net sale (purchase) of short-term investments | (3,846) | 41,974 | (47,559) |
| Net purchase of property and equipment | (392) | (246) | (433) |
| Investment in subsidiaries | — | (45,216) | (14,274) |
| Other | 215 | 334 | (981) |
| Net cash used | (4,023) | (5,238) | (65,185) |
| Cash flows from financing activities: | | | |
| Cash dividends paid | (6,813) | (5,985) | (3,868) |
| Issuance of common stock | 5,551 | 6,948 | 60,974 |
| Issuance of subordinated debentures | — | 5,155 | 25,774 |
| Line of credit, net | — | — | (19,800) |
| Net cash provided (used) | (1,262) | 6,118 | 63,080 |
| Net change in cash | (643) | 1,216 | (239) |
| Cash at beginning of year | 1,581 | 365 | 604 |
| Cash at end of year | $ 938 | $ 1,581 | $ 365 |

**19 — Segment Information**

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

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

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

Financial data by segment is as follows:

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| | | (in thousands) | |
| Revenues | | | |
| Premiums earned: | | | |
| Commercial lines | $112,711 | $ 99,657 | $ 71,471 |
| Personal lines | 181,787 | 169,322 | 125,322 |
| Total SAP premiums earned | 294,498 | 268,979 | 196,793 |
| GAAP adjustments | — | (3,140) | — |
| Total GAAP premiums earned | 294,498 | 265,839 | 196,793 |
| Net investment income | 18,472 | 15,907 | 13,316 |
| Realized investment gains | 1,803 | 1,466 | 1,368 |
| Other | 5,074 | 4,577 | 3,515 |
| Total revenues | $319,847 | $287,789 | $214,992 |

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| | | (in thousands) | |
| Income before income taxes and extraordinary item: | | | |
| Underwriting income: | | | |
| Commercial lines | $13,941 | $ 6,209 | $ 7,173 |
| Personal lines | 14,232 | 10,100 | 2,004 |
| SAP underwriting income | 28,173 | 16,309 | 9,177 |
| GAAP adjustments | 2,765 | 2,109 | 692 |
| GAAP underwriting income | 30,938 | 18,418 | 9,869 |
| Net investment income | 18,472 | 15,907 | 13,316 |
| Realized investment gains | 1,803 | 1,466 | 1,368 |
| Other | 1,132 | 1,263 | 883 |
| Income before income tax expense and extraordinary item | $52,345 | $37,054 | $25,436 |

**20 — Guaranty Fund and Other Insurance-Related Assessments**

We accrue for guaranty fund and other insurance-related assessments in accordance with SOP 97-3, "Accounting by Insurance and Other Enterprises for Insurance-Related Assessments." SOP 97-3 provides guidance for determining when an entity should recognize a liability for guaranty fund and other insurance-related assessments, how to measure that liability and when an asset may be recognized for the recovery of such assessments through premium tax offsets or policy surcharges. Our liabilities for guaranty fund and other insurance-related assessments were $3,064,791 and $4,140,878 at December 31, 2005 and 2004, respectively. These liabilities included $361,192 and $376,428 related to surcharges collected by us on behalf of regulatory authorities for 2005 and 2004, respectively.

**21— Interim Financial Data (unaudited)**

| | 2005 | | | |
|---|---|---|---|---|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Net premiums earned | $71,762,523 | $73,438,090 | $74,584,045 | $74,713,365 |
| Total revenues | 78,079,058 | 79,492,080 | 80,566,455 | 81,709,601 |
| Net losses and loss expenses | 41,537,896 | 39,807,658 | 41,071,801 | 45,124,542 |
| Net income | 8,417,088 | 8,903,275 | 9,777,157 | 9,851,977 |
| Net income per common share | | | | |
| Basic | 0.47 | 0.50 | 0.54 | 0.54 |
| Diluted | 0.46 | 0.48 | 0.52 | 0.52 |

| | 2004 | | | |
|---|---|---|---|---|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Net premiums earned | $62,699,478 | $65,498,402 | $67,958,382 | $69,682,332 |
| Total revenues | 68,001,661 | 70,692,422 | 73,613,653 | 75,480,902 |
| Net losses and loss expenses | 40,371,057 | 39,961,021 | 42,285,455 | 41,523,835 |
| Income before extraordinary item | 6,286,636 | 6,770,187 | 5,886,886 | 7,224,890 |
| Extraordinary item | 5,445,670 | — | — | — |
| Net income | 11,732,306 | 6,770,187 | 5,886,886 | 7,224,890 |
| Basic earnings per common share: | | | | |
| Income before extraordinary item | 0.37 | 0.39 | 0.33 | 0.41 |
| Extraordinary item | 0.31 | — | — | — |

| | | | | |
|---|---|---|---|---|
| Net income | 0.68 | 0.39 | 0.33 | 0.41 |
| Diluted earnings per common share: | | | | |
| Income before extraordinary item | 0.35 | 0.37 | 0.32 | 0.40 |
| Extraordinary item | 0.30 | — | — | — |
| Net income | 0.65 | 0.37 | 0.32 | 0.40 |

## Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2005 and 2004, 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, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Donegal Group Inc. and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005 in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Donegal Group Inc.'s internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 13, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Philadelphia, Pennsylvania

March 13, 2006

## Management’s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. Under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, our management has conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2005, based on the framework and criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the “COSO Framework”).

Based on our evaluation under the COSO Framework, our management has concluded that our internal control over financial reporting was effective as of December 31, 2005.

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

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

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

Donald H. Nikolaus
President and Chief Executive Officer

Jeffrey D. Miller
Senior Vice President and Chief Financial Officer

March 13, 2006

## Report of Independent Registered Public Accounting Firm

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

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Donegal Group Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Donegal Group Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that Donegal Group Inc. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also, in our opinion, Donegal Group Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2005 and 2004, 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, 2005, and our report dated March 13, 2006 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Philadelphia, Pennsylvania

March 13, 2006

## CORPORATE INFORMATION

Annual Meeting

April 20, 2006 at the Company's headquarters at 10:00 a.m.

Form 10-K

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

Market Information

Donegal Group's Class A common stock and Class B common stock are traded on the Nasdaq National Market under the symbols "DGICA" and "DGICB." The following table shows the dividends paid per share and the stock price range for each quarter during 2005 and 2004:

| Quarter | High | Low | Cash Dividend Declared Per Share |
|---|---|---|---|
| 2004 — Class A | | | |
| 1st | $18.00 | $13.28 | $ — |
| 2nd | 17.19 | 13.97 | .09 |
| 3rd | 15.97 | 13.85 | .09 |
| 4th | 18.45 | 14.01 | .18 |
| 2004 — Class B | | | |
| 1st | $16.10 | $12.75 | $ — |
| 2nd | 16.69 | 14.21 | .079 |
| 3rd | 16.16 | 13.88 | .079 |
| 4th | 17.25 | 12.60 | .158 |
| 2005 — Class A | | | |
| 1st | $21.24 | $15.50 | $ — |
| 2nd | 20.32 | 16.69 | .10 |
| 3rd | 23.99 | 19.32 | .10 |
| 4th | 24.93 | 20.24 | .20 |
| 2005 — Class B | | | |
| 1st | $18.83 | $14.06 | $ — |
| 2nd | 19.00 | 14.51 | .085 |
| 3rd | 20.00 | 16.56 | .085 |
| 4th | 24.00 | 17.40 | .17 |

Corporate Offices

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

Transfer Agent

Computershare Investor Services
P.O. Box 43069
Providence, Rhode Island 02940-3069
(800) 317-4445
Web Site: www.equiserve.com
Hearing Impaired: TDD: 800-952-9245

Dividend Reinvestment and Stock Purchase Plan

The Company offers a dividend reinvestment and stock purchase plan through its transfer agent.
For information contact:
Donegal Group Inc.
Dividend Reinvestment and Stock Purchase Plan
Computershare Investor Services
P.O. Box 43069
Providence, Rhode Island 02940-3069

Stockholders

The following represent the number of common stockholders of record as of December 31, 2005:

| | |
|---|---|
| Class A common stock | 785 |
| Class B common stock | 446 |

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 |
| Le Mars Insurance Company | Iowa |
| The Peninsula Insurance Company | Maryland |
| Peninsula Indemnity Company* | Maryland |

* Wholly owned by The Peninsula Insurance Company.

EXHIBIT 23

REPORT AND CONSENT OF
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Donegal Group Inc.:

The audits referred to in our report dated March 13, 2006 with respect to the consolidated financial statements of Donegal Group Inc. included the related financial statement schedules as of December 31, 2005, and for each of the years in the three-year period ended December 31, 2005, that are included in the annual report on Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects, the information set forth therein.

We consent to incorporation by reference in the registration statements (Nos. 333-06681, 333-25541, 333-26693, 333-61095, 333-93785, 333-94301, 333-89644, 333-62970, 333-62974 and 333-62976) on Form S-8 and registration statements (Nos. 333-59828 and 333-63102) on Form S-3 of Donegal Group Inc. of our reports dated March 13, 2006, with respect to the consolidated balance sheets of Donegal Group Inc. as of December 31, 2005 and 2004, 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, 2005, and all related financial statement schedules, management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2005 and the effectiveness of internal control over financial reporting as of December 31, 2005, which reports are incorporated by reference or appear in the December 31, 2005 annual report on Form 10-K of Donegal Group Inc.

/s/ KPMG LLP

Philadelphia, Pennsylvania

March 13, 2006

EXHIBIT 31.1

CERTIFICATION

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

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2005 of Donegal Group Inc.;

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

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

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

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

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected,

or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

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

Date: March 13, 2006

EXHIBIT 31.2

CERTIFICATION

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

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2005 of Donegal Group Inc.;

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

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

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

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

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the

registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

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

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

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

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

Date: March 13, 2006

EXHIBIT 32.1

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

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

1. The Company’s Form 10-K Annual Report for the period ended December 31, 2005 (the “Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

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

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

Date: March 13, 2006

EXHIBIT 32.2

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

Pursuant to Section 1350 of Title 18 of the United States Code, I, Jeffrey D. Miller, Vice President and Chief Financial Officer of Donegal Group Inc. (the “Company”), hereby certify that, to the best of my knowledge:

1. The Company’s Form 10-K Annual Report for the period ended December 31, 2005 (the “Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

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

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

Date: March 13, 2006