Donegal Group

Annual Report 2001

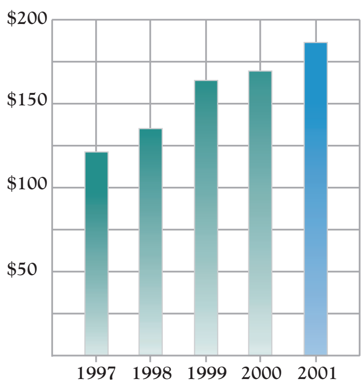
Donegal Insurance Group is an insurance holding company offering property and casualty insurance in various regions throughout the eastern United States through its wholly-owned subsidiaries Atlantic States Insurance Company, Pioneer Insurance Company, Southern Heritage Insurance Company and Southern Insurance Company of Virginia; and through a pooling agreement with its affiliate, Donegal Mutual Insurance Company.

We offer full lines of personal, farm and commercial products—including businessowners, commercial multiperil, automobile, homeowners, boatowners, farmowners, workers' compensation and other coverages. The Donegal Group conducts business through a network of approximately 1,500 independent insurance agencies.

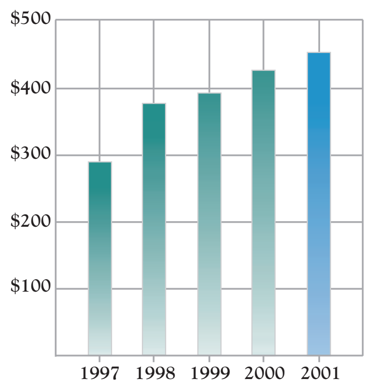
Financial Highlights

Year Ended December 31,	2001	2000	1999	1998	1997
INCOME STATEMENT DATA					
Net premiums earned	$167,769,854	$151,646,199	$145,517,457	$117,454,194	$108,817,880
Investment income	15,885,544	16,394,747	13,590,695	12,343,793	11,849,538
Total revenue	185,163,623	170,581,587	161,739,336	132,232,316	123,199,214
Net income	5,818,131	8,836,780	6,795,197	9,022,737	10,243,285
Net income per common share					
Basic	0.65	1.01	0.82	1.11	1.28
Diluted	0.64	1.01	0.82	1.09	1.27
BALANCE SHEET DATA					
Total assets	$456,632,372	$426,008,780	$389,688,804	$376,742,094	$296,695,369
Stockholders' equity	120,928,349	114,129,591	103,792,334	100,915,178	89,768,653
Book value per share	13.44	12.88	12.28	12.30	11.16

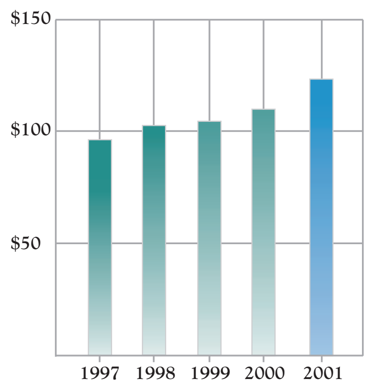
Total Revenues *(in millions)*

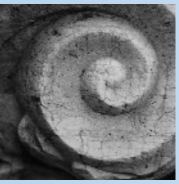


Total Assets *(in millions)*



Stockholder's Equity *(in millions)*





To Our Shareholders and Friends

The year 2001 marked the passage of fifteen years since the initial public offering of Donegal Group. Since our inception, we have consistently outpaced the industry in terms of growth and profitability. Our premium growth goals were realized once again in 2001 as we began to reap the benefits of increasing rates in many of our core lines of business. These rate increases were greatly needed as we, like many insurance companies, experienced increasing loss trends over the past several years. Although we continued our trend of outpacing the industry in the profitability of our operations, the earnings we posted during the year did not meet our expectations. We recognize that 2001 was a challenging year for our industry, and we have already begun to implement measures to return our profitability to acceptable levels in 2002 and beyond.

Our total revenues for 2001 were $185,163,623, an 8.5 percent increase over the $170,581,587 in revenues for 2000. This increase resulted primarily from a 10.6 percent increase in net premiums earned. Net premiums written also increased 10.6 percent over the amount posted in 2000, reflecting the continuing positive impacts of rate increases, organic growth, and a 5 percent increase in the percentage of pooled business allocated to the Company as of July 1, 2000. As we continue to monitor the profitability of individual lines of business, we are continuing to increase rates in both personal and commercial lines. We are pleased with growth achieved in targeted states within the region served by our Southern Heritage Insurance Company subsidiary in 2001 and continue to see significant growth potential in this market as we proceed with the introduction of commercial products.

Net income decreased to $5,818,131, or $.64 per share on a diluted basis, in 2001, compared to $8,836,780, or $1.01 per share on a diluted basis, in 2000. The primary factors in the reduced earnings were the impact of loss and loss expense reserve strengthening of approximately $4.2 million and guaranty fund assessment accruals for the Reliance Insurance Company insolvency. The reserve strengthening was necessary to address the loss development trends that became evident in the fourth quarter of the year in several commercial lines of business. This measure was consistent with our history of strong reserving practices, and we firmly believe the scope of the reserve strengthening has fully addressed our development issues.

Our 2001 GAAP combined ratio of 103.8% compared favorably to the projected statutory insurance industry average combined ratio, which is expected to exceed 118.0% percent for the year. The industry combined ratio estimate includes nearly six points from the September 11 losses. The combined ratio is the key measure of profitability from insurance underwriting and is a principal indicator of the health and soundness of individual insurance companies. It remains our goal to attain underwriting profitability – reflected in a combined ratio less than 100 percent – and we are hopeful that our increasing premium base and continuing focus on expense control will allow us to reach that goal in 2002. In order to reduce operating expenses and simplify our corporate structure, we have taken steps to merge several of our subsidiaries. Two companies were merged into Atlantic States Insurance Company during 2001, and we hope to merge two additional subsidiaries during 2002.

Our stockholders' equity increased during the year to $120,928,349 at year-end, an increase of 6.0 percent over year-end 2000. Book value per share increased to $13.44 per share at year-end, an increase of 4.7 percent over the book value at December 31, 2000. Although it had no impact on book value per share, the successful implementation of our stock recapitalization in 2001 provides strategic alternatives in the acquisition of additional companies as opportunities become available.

As we reflect on the year 2001, we recognize that the events of September 11 will forever be etched in our memories. The tragedies we witnessed that day profoundly impacted our individual lives, and they affected countless businesses and industries as a whole. The insurance industry in particular incurred enormous costs related to the unprecedented damages inflicted upon life and property. Although our companies did not have losses from the September 11 tragedies, we will be affected by significant changes in the overall insurance market. A large portion of the World Trade Center losses will be covered by reinsurance. As a result, the cost of reinsurance has escalated significantly. Although reinsurers look favorably on the nature and profile of our book of business relative to many of our competitors, we will not escape the impact of increased reinsurance rates and reduced ceding commissions.

As a direct result of the reinsurance increases as of January 1, 2002 and overall decrease in our profitability in 2001, it became necessary to take immediate action to reduce our expense levels in order to achieve an acceptable expense ratio. We announced modest commission schedule reductions to our agency force in late December that will become effective in the beginning of the second quarter of 2002. We also implemented a cost reduction plan in early 2002 to further reduce operating expenses. Included in this plan is a restructuring that results in the elimination of certain full-time equivalent employee positions across our organization as well as reductions resulting from attrition and automation. The combination of these measures will result in significant improvement in our profitability, and we believe we have aligned our expense structure with the expectation of the marketplace for the foreseeable future.

Donald H. Nikolaus
President

Philip H. Glatfelter, II
Chairman of the Board

It is undeniable that we face a challenging environment in these unprecedented times in our nation and industry. We want to express our sincere gratitude to the employees and agents who continue to work together in these difficult times to assure the ongoing success of the Donegal Group. In spite of the challenges, our companies are poised to continue our positive approach to the insurance marketplace in the regions we serve, offering our full lines of insurance products at competitive rates.

We have streamlined our corporate structure and undertaken initiatives to improve profitability. We continue to evaluate potential acquisition opportunities in our pursuit of growth in our regions and as we seek to expand our geographical service area. As we look forward to the future prospects for prudent growth and improved profitability, we value greatly the trust of our stockholders. We will continue to balance our growth objectives with the conservative strategies that have yielded successful results in the past. As we look ahead, we remain committed to the perpetuation of our leadership among regional insurance carriers in our regions.

Donald H. Nikolaus

Donald H. Nikolaus
President

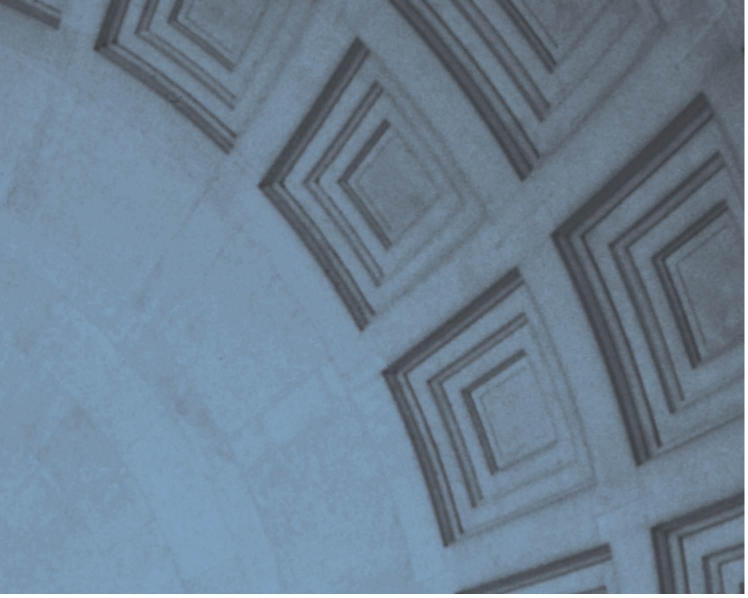
MAINTAINING STABILITY IN CHALLENGING TIMES

When Donegal Group was formed and its stock was offered to the public in 1986, four commitments were made. We said we would increase our profitability, aim for prudent growth, provide a diversified business mix, and improve the efficiency of our operations. Fifteen years later, those same commitments are still very much the core of our business philosophy. We continue our pursuit of prudent expansion as we maintain our strong focus on underwriting profitability. We continue to strive for balance in our book of business as we diversify geographically and in the mix of our products in both personal and commercial lines. Through changes in our corporate structure this past year and ongoing technology initiatives, we have proven our ability and commitment to continually improve our operating efficiency. Donegal Group continues to hold fast to the sound business practices that have proven successful in the past and remains true to the traditions that have helped our affiliated companies grow and prosper for well over 100 years. As we have fulfilled our commitments, our organization has grown to the current service area including fourteen states and utilizing an agency force numbering more than 1,500 independent agencies.

PURSUING GROWTH AND PROFITABILITY

Property and casualty industry experts are projecting premium rate growth to continue throughout 2002, as the industry continues its attempt to recover from the effects of the September 11 tragedy and the soft market conditions that resulted in deteriorating underwriting results over the past several years. Within the past year, our subsidiaries have gradually increased rates in most lines of business we write, and we anticipate further increases in rates in 2002. While we have not abandoned our objective to increase market share in our operating regions, we are placing increased emphasis on the quality of business we are accepting and the adequacy of our product pricing.

We have worked very hard over the past several years to improve our brand recognition in our regional marketplace, and our advertising campaigns have been well received. We are particularly pleased with the success of our cooperative advertising program with our agents, whereby agents can utilize our branded marketing



materials to attract customers to their agency. We are adding professionally produced advertising materials to our portfolio on a regular basis, and we will continue to aggressively promote this service to our agents as an effective marketing tool. We continue to pursue affinity groups as a means of attracting quality business and establishing strong business relationships within our agents' communities. As we pursue profitable growth, we maintain our commitment to the independent agency system and are working to solidify agency relationships in the midst of a challenging business environment. We are pleased that many agencies qualified for our new business travel incentive during 2001, and we look forward to the "Cruise of the Century" in May 2002 when their sales efforts will be recognized and rewarded.

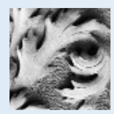
We have begun to introduce commercial products through our Southern Heritage Insurance Company agency force in our target states of Georgia, North Carolina and Tennessee. A great deal of effort was expended in developing these products during 2001, and we look forward to additional premium growth in this region as these new products are rolled out in 2002. We are also pleased with the premium growth in our New York State business region. As we continue to build our agency force and expand our market presence in this state, and we are optimistic for additional production in key areas where we believe there is potential for profitable growth.

STREAMLINING OUR CORPORATE STRUCTURE

Donegal Group purchased the stock of Pioneer Insurance Company of New York from Donegal Mutual Insurance Company on January 1, 2001. With the addition of this subsidiary, Donegal Group held ownership of six separate insurance companies. In our ongoing commitment to control operating expenses, it was determined that the benefits derived from this corporate structure did not outweigh the economic and administrative burden of maintaining six separate charters. Therefore, we implemented a plan to simplify our organizational structure by merging several subsidiaries. During 2001, Delaware Atlantic Insurance Company and Pioneer Insurance Company of New York were merged into Atlantic States Insurance Company. Pending regulatory approval in early 2002, we plan to merge Southern Heritage Insurance Company into Southern Insurance Company of Virginia and Pioneer Insurance Company of Ohio into Atlantic States Insurance Company. Through cross licensing of the

remaining companies and our affiliate, Donegal Mutual Insurance Company, we will retain the ability to offer multiple product tiers in those states and product lines where only one tier per company is permitted. Significant savings will be realized in time from the reduction in license fees, examination fees and administrative costs related to the merged entities.

In April 2001, we successfully implemented a corporate initiative to revise our capital structure. The company's common stock was reclassified as Class B Common Stock, and we introduced a new class of stock designated as Class A Common Stock with one-tenth of a vote per share. Through a reverse stock split of the Class B shares and stock dividend of Class A shares, each stockholder maintained the same total number of shares and same relative voting power. The purpose of the new structure was to enable Donegal Group to issue additional Class A Common Stock to raise equity capital to fund future acquisitions without materially adversely affecting the voting rights of any stockholder, including our majority stockholder, Donegal Mutual Insurance Company. We are confident that all of our stockholders will benefit from the additional flexibility provided by this new capital structure as acquisition opportunities arise in the future.



INVESTING IN TECHNOLOGY

We continue to believe that our ability to utilize automation in the processing and delivery of our products represents a major contributing factor in determining the level of our ongoing success as a regional insurance organization. Consequently, we continue to invest in technology designed to streamline our operations and increase the efficiency of our service to agents and policyholders. A major project is underway to allow for significantly enhanced agency upload functionality. The enhanced agency upload system will include such features as automated underwriting, automated report ordering and online price quoting. These real-time functions will be made available to our agents through their agency management system or directly through our web site. We plan to begin introducing this increased functionality in the second quarter of 2002, and look forward to the operational efficiencies this system will provide.

The “Donegal Express” area of our web site continues to be well received by our agents as they have instant access to their customers’ billing information. We continue to add web enhancements to further improve our communications with our agents, and will soon introduce the availability of claim inquiry and reporting functions as well as online images of manuals and policy documents. The vast majority of our agents have registered to access the secure agents area of our web site, and we consider this technology a vital tool in providing critical information to our agency force.

We introduced the “Automatic Payment Plan” electronic funds transfer option to our policyholders in 2001. The Automatic Payment Plan allows a customer to pay insurance premiums through monthly withdrawals from a checking or savings account. The added convenience of this payment option has been enthusiastically received with initial interest exceeding our expectations. The electronic payments are automatically applied to our billing system, requiring no intervention on the part of our personnel. We expect to benefit from the reduced cost of processing these payments, as well as the increased retention of business generated by the convenience of this payment method.

Two major technology initiatives were undertaken in 2001 to improve our operating efficiency. We upgraded our mainframe hardware during 2001 to improve processing speed and to allow for future expansion. We also began to work on an imaging project that we believe will have far-reaching benefits in our operation. Images of printed documents, such as policy forms, are automatically loaded into the imaging system. Other required documents that are not computer-generated, such as policy application forms, are scanned and indexed so that they are included in an electronic policy file. These electronic images are immediately available to our personnel, allowing faster access to information and increased efficiency in the handling of policy documents. We have high expectations for productivity gains as this system becomes fully operational during 2002.

Construction of our Technology Center home office addition is progressing according to schedule and is expected to be completed in late Spring 2002. This state-of-the-art facility will house all mainframe and network server equipment, as well as provide increased office space for our information services personnel. We believe this facility will address our technology needs for the foreseeable future and will allow us to fulfill our commitment to utilize technology to the fullest extent possible in our business processes.

Selected Consolidated Financial Data

Year Ended December 31,	2001	2000	1999	1998	1997
Income Statement Data:					
Premiums earned	$167,769,854	$151,646,199	$145,517,457	$117,454,194	$108,817,880
Investment income, net	15,885,544	16,394,747	13,590,695	12,343,793	11,849,538
Realized investment gains (losses)	(880,254)	170,852	(38,702)	(13,562)	311,155
Total revenues	185,163,623	170,581,587	161,739,336	132,232,316	123,199,214
Income before income taxes	7,091,729	11,743,028	3,844,641	11,697,666	13,924,355
Income taxes (benefit)	1,273,598	2,906,248	(2,950,556)	2,674,929	3,681,070
Net income	5,818,131	8,836,780	6,795,197	9,022,737	10,243,285
Basic earnings per common share	0.65	1.01	0.82	1.11	1.28
Diluted earnings per common share	0.64	1.01	0.82	1.09	1.27
Cash dividends per share of common stock (a)	N/A	0.36	0.36	0.34	0.29
Cash dividends per share of Class A common stock (a)	0.40	N/A	N/A	N/A	N/A
Cash dividends per share of Class B common stock (a)	0.36	N/A	N/A	N/A	N/A
Balance Sheet Data at Year End:					
Total investments	$300,633,355	$289,344,642	$268,010,854	$261,506,778	$209,968,608
Total assets (b)	456,632,372	426,008,780	389,688,804	376,742,094	296,695,369
Debt obligations	27,600,000	40,000,000	37,000,000	37,500,000	10,500,000
Stockholders' equity	120,928,349	114,129,591	103,792,334	100,915,178	89,768,653
Stockholders' equity per share	13.44	12.88	12.28	12.30	11.16

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

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

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

(b) Certain amounts in the financial statements have been reclassified from those previously presented. Total assets have been reduced in the consolidated balance sheet as discussed in Note 2a to the consolidated financial statements.

Financial Information

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

Donegal Group Inc. ("DGI" or the "Company") is a regional insurance holding company doing business in the Mid-Atlantic and Southern states through its four wholly owned property-casualty insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Southern Heritage Insurance Company ("Southern Heritage") and Pioneer Insurance Company of Ohio ("Pioneer-Ohio") (collectively "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. DGI was formed in September 1986 by Donegal Mutual Insurance Company (the "Mutual Company"), which owns 63% of the outstanding common shares of the Company as of December 31, 2001.

Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 70% of the pooled business (65% prior to July 1, 2000). Southern cedes 50% of its business to the Mutual Company. Because the Mutual Company places substantially all of the business assumed from Southern into the pool, from which the Company has a 70% allocation, the Company's results of operations include approximately 85% of the business written by Southern.

In addition to the Company's Insurance Subsidiaries, it also owned all of the outstanding stock of Atlantic Insurance Services, Inc., ("AIS"), an insurance services organization. The Company sold all of the outstanding shares of AIS on October 1, 1999.

During 2000, the Company acquired 45% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a bank holding company. The remaining 55% of the outstanding stock of DFSC is owned by the Mutual Company.

On January 3, 2001, the Company announced that it had purchased all of the outstanding stock of Pioneer Insurance Company of New York ("Pioneer-New York") from the Mutual Company effective January 1, 2001. The purchase price was $4,441,311, representing Pioneer-New York's adjusted statutory equity at December 31, 2000. The acquisition has been accounted for as a reorganization of entities under common control, similar to a pooling of interests, as both Pioneer-New York and the Company are under the common management and control of the Mutual Company. As such, the Company's financial statements have been restated to include Pioneer-New York as a consolidated subsidiary. In connection with this transaction, the Company issued the Mutual Company a $4,441,311 note, which bears a 6% rate and was due in one year. The due date was subsequently extended to January 2003. The 6% rate was based upon commercial market rates in effect as of January 1, 2001.

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

Transactions with Affiliates

The Company's insurance subsidiaries have various reinsurance arrangements with the Mutual Company, which include a pooling agreement with Atlantic States, a 50% quota share contract with Southern, catastrophe reinsurance agreements with each of the subsidiaries and excess of loss reinsurance agreements with Southern, Southern Heritage and Pioneer-Ohio. The Mutual Company also has 100% retrocessional agreements with Southern, Southern Heritage and Pioneer-Ohio. Each contract is reviewed by a Coordinating Committee comprised of two board members of the Company and two board members of the Mutual Company. This committee reviews the business purpose and terms of each agreement based on degree of risk, fairness to the participating companies and market conditions. The committee must unanimously approve all agreements and all changes to existing agreements between the Company's subsidiaries and the Mutual Company.

The pooling agreement between the Mutual Company and Atlantic States 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. Each company participating in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposure of a size commensurate with its own capital and surplus. In addition, the ability of the Company to raise capital, and infuse that capital into Atlantic States, provides the participants of the pool with an ability to grow their total direct premiums at a greater rate than would be possible without the existence of the pool. Premiums, losses, loss expenses and underwriting expenses are shared proportionately by each of the participants, with Atlantic States currently assuming 70% of the pooled business and the Mutual Company retaining 30% of the pooled business.

The 50% quota share reinsurance contract between Southern and the Mutual Company provides additional capacity for direct premium growth to Southern during periods of growth that exceeds Southern's ability to finance that growth through internal equity. Premiums, losses and loss expenses are shared equally by the participants with the Mutual Company paying commissions to Southern to reimburse its costs related to the underwriting process.

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 a level that is more in line with each company's size, underwriting profile and equity position. The retention levels of these contracts are more appropriate for each company than the retention levels included within reinsurance contracts with outside reinsurers, which may be appropriate for the insurance companies taken as a whole but would be excessive for any individual company within the group.

The 100% retrocessional agreements are intended to provide the subsidiaries with the same A.M. Best rating (currently "A") as the Mutual Company, which these companies could not achieve without these contracts in place.

The Mutual Company provides facilities, management and other services to the Company, and the Company reimburses the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of the Company and the Mutual Company in the pooling arrangement, and management of both the Company and the Mutual Company consider this allocation to be reasonable. Charges for these services totalled $29,298,569, $26,985,080 and $27,466,898 for 2001, 2000 and 1999, respectively.

Critical Accounting Policies

The Company's financial statements are combined with those of its subsidiaries and presented on a consolidated basis in accordance with U.S. generally accepted accounting principle.

The Company uses estimates and assumptions that can have a significant effect on the amounts that are reported in its financial statements. The Company believes the following are its most significant accounting policies as they may require a higher degree of judgment and estimation.

Liability for Losses and Loss Expenses

The most significant estimates relate to reserves for losses and loss expenses. The liability represents estimates of the ultimate unpaid cost of claims incurred, including claims incurred but not reported to the Company as of the close of the reporting period. The estimates of losses for reported claims are based on reviews of the individual claims considering known information and the policy provisions relating to the loss. Estimates of losses and loss expenses for unreported claims are established based on historical data by line of insurance as adjusted for current conditions considering factors such as inflation, recent trends and other analysis of costs. The Company continually reviews and analyzes its estimates, but actual losses may turn out to be significantly different than expected when the estimates were made.

Investments

In the Company's investment portfolio, the difference between cost and the fair value of investments is monitored regularly. The Company evaluates significant declines in fair value below cost on an individual investment basis. This evaluation considers the magnitude of the decline below cost, the period of time the investment has been significantly below cost and the prospects for the fair value to recover in the near term. If any investment experiences a decline in value that is believed to be other than temporary, the cost basis of the investment is written down and a realized loss is recorded in earnings.

Reinsurance

Reinsurance accounting is followed when risk transfer requirements have been met. These requirements may involve significant assumptions being made related to the amount and timing of expected cash flows, as well as interpretation of the underlying contract terms.

Policy Acquisition Costs

Policy acquisition costs, consisting primarily of commissions, premium taxes and certain other variable underwriting costs, are deferred and amortized over the period in which the premiums are earned. Anticipated losses and loss expenses, expenses for maintenance of policies in force and anticipated investment income are estimated in the determination of the recoverability of deferred acquisition costs. Future changes in estimates, the most significant of which is expected loss and loss expenses, may require adjustment to policy acquisition costs.

Results of Operations 2001 Compared to 2000

Total revenues for 2001 were $185,163,623, which were $14,582,036, or 8.5%, greater than 2000. Net premiums earned increased to $167,769,854, an increase of $16,123,655, or 10.6%, over 2000. The change in Atlantic State's share of the pooling arrangement with the Mutual Company from 65% to 70% effective July 1, 2000, accounted for $4,273,297 of the increase in net premiums earned. Direct premiums written of the combined pool of Atlantic States and the Mutual Company increased $23,152,222 or 13.2%. A 4.0% increase in the direct premiums written of Southern, an 8.6% increase in the direct premiums written of Pioneer-Ohio and a 9.6% increase in the direct premiums written of Southern Heritage accounted for the majority of the remaining change. The Company reported net realized investment losses of $880,254 in 2001 compared to net realized investment gains of $170,852 in 2000. During 2001 and 2000, certain investments trading below cost had declined on an other-than-temporary basis. Losses of $1,462,913 and $436,943 were included in net realized investment gains (losses) for these investments in 2001 and 2000, respectively. The remaining realized gains and losses in both years resulted from normal turnover of the Company's investment portfolio. As of December 31, 2001, 100.0% of the Company's bond portfolio was classified as Class 1 (highest quality) by the National Association of Insurance Commissioners' Securities Valuation Office. Investment income decreased $509,203 in 2001. An increase in the average invested assets from $278,677,748 to $294,988,999, offset by a decrease in the average yield to 5.3% from 5.9% in 2000, accounted for the change.

The GAAP combined ratio of insurance operations was 103.8% in 2001, compared to 101.8% in 2000. The combined ratio is the sum of the ratios of incurred losses and loss expenses to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in 2001 was 70.5% compared to 68.8% in 2000. The increased loss ratio reflected the impact of loss and loss expense reserve strengthening of approximately $4.2 million in the commercial automobile and workers' compensation lines of business. The commercial lines loss ratio increased significantly to 72.7% in 2001 compared to 67.0% in 2000. The personal lines loss ratio decreased from 70.3% in 2000 to 69.2% in 2001. The commercial automobile and workers' compensation loss ratios showed considerable deterioration in 2001 with the commercial automobile loss ratio increasing to 85.0% in 2001 compared to 78.1% in 2000 and the workers' compensation loss ratio increasing to 82.5% in 2001 compared to 64.2% in 2000. The expense ratio for 2001 was 32.3% compared to 32.1% in 2000 with the dividend ratio increasing slightly to 1.0% in 2001 compared to 0.9% in 2000. The expense ratio in 2001 included a guaranty fund assessment of approximately $543,000 resulting from the insolvency of Reliance Insurance Company. This assessment accounted for most of the increase in the expense ratio.

Income tax expense was $1,273,598, an effective rate of 18.0%, compared to $2,906,248, an effective rate of 24.7% in 2000. Tax exempt interest represented a larger proportion of net income before taxes in 2001 as compared to 2000, accounting for most of this difference.

Results of Operations 2000 Compared to 1999

Total revenues for 2000 were $170,581,587, which were $8,842,251, or 5.5%, greater than 1999. Net premiums earned increased to $151,646,199, an increase of $6,128,742, or 4.2%, over 1999. The change in Atlantic State's share of the pooling arrangement with the Mutual Company from 65% to 70% effective July 1, 2000, accounted for $4,113,078 of the increase in net premiums earned. Direct premiums written of the combined pool of Atlantic States and the Mutual Company increased $13,851,692 or 9.0%. A 5.1% increase in the direct premiums written of Southern, a 2.1% decrease in the direct premiums written of Delaware, a 13.2% increase in the direct premiums written of Pioneer-New York, a 25.4% increase in the direct premiums written of Pioneer-Ohio and a 15.6% decrease in the direct premiums written of Southern Heritage accounted for the majority of the remaining change. The Company reported net realized investment gains of $170,852, compared to net realized investment losses of $38,702 in 1999. During 2000, certain investments trading below cost had declined on an other-than-temporary basis. Losses of $436,943 were included in net realized investment gains for these investments in 2000. Net realized gains and losses in 1999 resulted from normal turnover of the Company's investment portfolio. As of December 31, 2000, 100.0% of the Company's bond portfolio was classified as Class 1 (highest quality) by the National Association of Insurance Commissioners' Securities Valuation Office. Investment income increased $2,804,052 in 2000. An increase in the average invested assets from $264,758,816 to $278,677,748, and an increase in the average yield to 5.9% from 5.1% in 1999, accounted for the change.

The GAAP combined ratio of insurance operations was 101.8% in 2000, compared to 106.5% in 1999. The GAAP combined ratio is the sum of the ratios of incurred losses and loss expenses to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in both 2000 and 1999 was 68.8%. The commercial lines loss ratio decreased from 68.8% in 1999 to 67.0% in 2000. The personal lines loss ratio increased from 69.7% in 1999 to 70.3% in 2000. The expense ratio for 2000 was 32.1%, compared to 36.8% in 1999, with the dividend ratio remaining unchanged at 0.9%. The expense ratio in 1999 was adversely affected by a charge to earnings resulting from a restructuring charge of $1.6 million which increased the expense ratio by 1.1%.

Income tax expense (benefit) was $2,906,248, compared to $(2,950,556) in 1999. The Company benefited from a federal income tax law change in 1999.

Liquidity and Capital Resources

The Company generates sufficient funds from its operations and maintains a high degree of liquidity in its investment portfolio. The primary source of funds to meet the demands of claim settlements and operating expenses are premium collections, investment earnings and maturing investments. As of December 31, 2001, the Company had no material commitment for capital expenditures.

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

As of December 31, 2001, pursuant to a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank, the Company had unsecured borrowings of $27.6 million. Such borrowings were made in connection with the acquisitions of Delaware, Pioneer-Ohio and Southern Heritage and various capital contributions to the subsidiaries. As of December 31, 2001, the Company may borrow up to $32 million at interest rates equal to the bank's then current prime rate or the then current London interbank Eurodollar bank rate plus 1.70%. At December 31, 2001, the interest rates were 4.75% on an outstanding prime rate balance of $2.6 million, 3.825% on an outstanding Eurodollar rate balance of $10 million and 3.6375% on another Eurodollar rate balance of $15 million. In addition, the Company pays a rate of $^{3}/_{10}$ of 1% per annum on the average daily unused portion of the bank's commitment. On each July 27, the credit line is reduced by $8 million. Any outstanding loan in excess of the remaining credit line, after such reduction will then be payable.

The Company's principal sources of cash with which to meet obligations and pay stockholder dividends are dividends from the Insurance Subsidiaries which are required by law to maintain certain minimum surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. The Insurance Subsidiaries are also subject to Risk Based Capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 2001, all four companies' statutory capital and surplus were substantially above the RBC requirements. Amounts available for distribution as dividends to DGI without prior approval of the insurance regulatory authorities in 2002 are $8,612,490 from Atlantic States, $1,086,348, from Southern, $552,447 from Pioneer-Ohio and $3,514,487 from Southern Heritage.

Net unrealized gains (losses) resulting from fluctuations in the fair value of investments reported in the balance sheet at fair value were $2,861,765 (net of applicable federal income tax benefit) at December 31, 2001, and $(199,063) (net of applicable federal income tax) at December 31, 2000.

Credit Risk

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

The Company's Insurance Subsidiaries have reinsurance agreements in place with the Mutual Company, as described in Note 2 of the financial statements, and with a number of other major authorized reinsurers, as described in Note 8 of the financial statements.

Impact of Inflation

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

Quantitative and Qualitative Disclosure About Market Risk

Interest Rate Risk

The Company's exposure to market risk for changes in interest rates is concentrated in its investment portfolio and, to a lesser extent, its debt obligations. The Company monitors this exposure through periodic reviews of asset and liability positions. Estimates of cash flows and the impact of interest rate fluctuations relating to the investment portfolio are modeled regularly.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 2001 are as follows:

	Principal Cash Flows	Weighted-Average Interest Rate
Fixed maturities and short-term investments:		
2002	$ 37,038,816	3.84%
2003	19,700,000	5.74%
2004	24,025,000	5.79%
2005	28,632,768	5.91%
2006	48,879,557	5.83%
Thereafter	119,957,853	5.93%
Total	$278,233,994	
Market value	$284,732,437	
Debt		
2002	$ 3,600,000	3.81%
2003	8,000,000	3.81%
2004	8,000,000	3.81%
2005	8,000,000	3.81%
Total	$ 27,600,000	
Fair value	$ 27,600,000	

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

Equity Price Risk

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

The combined total of realized and unrealized equity investment losses were $131,146, $650,229, and $394,931 in 2001, 2000, and 1999, respectively. During these three years the largest total equity investment gain and (loss) in a quarter was $829,914 and $(730,481), respectively.

Donegal Group Inc.

Consolidated Balance Sheets

December 31,	2001	2000*
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value $86,939,393 and $144,662,436)	$ 85,322,965	$143,181,718
Available for sale, at fair value (amortized cost $170,269,584 and $114,524,472)	173,718,844	114,611,183
Equity securities, available for sale, at fair value (cost $16,630,618 and $12,500,558)	17,517,346	12,112,236
Short-term investments, at cost, which approximates fair value	24,074,200	19,439,505
Total investments	300,633,355	289,344,642
Cash	4,075,288	5,182,988
Accrued investment income	3,765,076	4,002,464
Premiums receivable	24,143,531	21,758,502
Reinsurance receivable	67,853,174	54,543,884
Deferred policy acquisition costs	13,604,215	12,284,214
Federal income taxes receivable	292,618	259,962
Deferred tax asset, net	7,474,730	7,690,886
Prepaid reinsurance premiums	29,593,467	24,712,384
Property and equipment, net	4,568,652	5,236,483
Accounts receivable—securities	50,023	234,817
Other	578,243	757,554
Total assets	$456,632,372	$426,008,780
Liabilities and Stockholders' Equity		
Liabilities		
Losses and loss expenses	$179,839,905	$156,476,124
Unearned premiums	114,079,264	99,940,381
Accrued expenses	7,186,107	5,877,475
Reinsurance balances payable	839,156	1,634,975
Cash dividend declared to stockholders	869,877	797,282
Borrowings under line of credit	27,600,000	40,000,000
Accounts payable—securities	—	959,652
Due to affiliate	4,015,074	4,528,996
Other	1,274,640	1,664,304
Total liabilities	335,704,023	311,879,189
Stockholders' Equity		
Preferred stock, $1.00 par value, authorized 2,000,000 shares; none issued		
Common stock, $1.00 par value, authorized 20,000,000 shares, issued 0 and 8,980,977 shares and outstanding 0 and 8,858,689 shares	—	8,980,977
Class A common stock, $.01 par value, authorized 30,000,000 shares, issued 6,097,214 and 0 shares and outstanding 6,015,690 and 0 shares	60,972	—
Class B common stock, $.01 par value, authorized 10,000,000 shares, issued 3,021,965 and 0 shares and outstanding 2,981,203 and 0 shares	30,220	—
Additional paid-in capital	58,887,715	46,969,840
Accumulated other comprehensive income (loss)	2,861,765	(199,063)
Retained earnings	59,979,425	59,269,593
Treasury stock, at cost	(891,748)	(891,756)
Total stockholders' equity	120,928,349	114,129,591
Total liabilities and stockholders' equity	$456,632,372	$426,008,780

*Restated - see note 1

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Income and Comprehensive Income

Year Ended December 31,	2001	2000*	1999*
Statements of Income			
Revenues			
Net premiums earned (includes affiliated reinsurance of $71,989,136, $63,989,424 and $60,234,261)	$167,769,854	$151,646,199	$145,517,457
Investment income, net of investment expenses	15,885,544	16,394,747	13,590,695
Installment payment fees	1,587,396	1,532,792	1,456,918
Lease income	801,083	836,997	819,474
Service fees	—	—	393,494
Net realized investment gains (losses)	(880,254)	170,852	(38,702)
Total revenues	185,163,623	170,581,587	161,739,336
Expenses			
Net losses and loss expenses (includes affiliated reinsurance of $50,283,481, $36,767,436 and $38,549,795)	118,177,549	104,383,176	100,080,616
Amortization of deferred policy acquisition costs	27,194,000	25,319,000	24,931,000
Other underwriting expenses	27,000,485	23,355,781	28,648,951
Policy dividends	1,691,759	1,330,330	1,341,294
Interest	2,247,465	3,285,036	1,535,249
Other	1,760,636	1,165,236	1,357,585
Total expenses	178,071,894	158,838,559	157,894,695
Income before income tax expense (benefit)	7,091,729	11,743,028	3,844,641
Income tax expense (benefit)	1,273,598	2,906,248	(2,950,556)
Net income	$ 5,818,131	$ 8,836,780	$ 6,795,197
Net income per common share			
Basic	$ .65	$ 1.01	$ .82
Diluted	$ .64	$ 1.01	$ .82
Statements of Comprehensive Income			
Net income	$ 5,818,131	$ 8,836,780	$ 6,795,197
Other comprehensive income (loss), net of tax			
Unrealized gains (losses) on securities:			
Unrealized holding gain (loss) arising during the period, net of income tax expense (benefit) of $1,277,504, $1,057,179, and $(1,804,294)	2,479,860	2,020,267	(3,459,669)
Reclassification adjustment for (gains) losses included in net income, net of income tax expense (benefit) of $(299,286), $58,090, and $(13,159)	580,968	(112,762)	25,543
Other comprehensive income (loss)	3,060,828	1,907,505	(3,434,126)
Comprehensive income	$ 8,878,959	$ 10,744,285	$ 3,361,071

*Restated - see note 1

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Stockholders' Equity

	Common Stock						Additional	Accumulated Other			Total
	Prior Shares	Class A Shares	Class B Shares	Prior Amount	Class A Amount	Class B Amount	Paid-In Capital	Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Stockholders' Equity
Balance, January 1, 1999*	8,325,221			$8,325,221	$	$	$42,330,011	$ 1,327,558	$49,824,144	$(891,756)	$100,915,178
Issuance of common stock	248,989			248,989			2,265,426				2,514,415
Net income									6,795,197		6,795,197
Other comprehensive loss								(3,434,126)			(3,434,126)
Cash dividends									(2,998,330)		(2,998,330)
Balance, December 31, 1999*	8,574,210			$8,574,210	$	$	$44,595,437	$(2,106,568)	$53,621,011	$(891,756)	$103,792,334
Issuance of common stock	406,767			406,767			2,349,773				2,756,540
Net income									8,836,780		8,836,780
Other comprehensive income								1,907,505			1,907,505
Grant of stock options							24,630		(24,630)		—
Cash dividends									(3,163,568)		(3,163,568)
Balance, December 31, 2000*	8,980,977			$8,980,977	$	$	$46,969,840	$ (199,063)	$59,269,593	$(891,756)	$114,129,591
Issuance of common stock	61,830	60,144	3,758	61,830	601	38	1,200,202				1,262,671
Recapitalization	(9,042,807)	6,027,975	3,013,987	(9,042,807)	60,280	30,140	8,949,361			8	(3,018)
Net income									5,818,131		5,818,131
Cash dividends									(3,466,947)		(3,466,947)
Exercise of stock options		9,095	4,220		91	42	126,960				127,093
Grant of stock options							1,641,352		(1,641,352)		—
Other comprehensive income								3,060,828			3,060,828
Balance, December 31, 2001	—	6,097,214	3,021,965	$ —	$ 60,972	$ 30,220	$58,887,715	$ 2,861,765	$59,979,425	$(891,748)	$120,928,349

*Restated - see note 1

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Cash Flows

Year Ended December 31,	2001	2000	1999
Cash Flows from Operating Activities:			
Net income	$ 5,818,131	$ 8,836,780	$ 6,795,197
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,127,510	982,926	1,078,594
Realized investment (gains) losses	880,254	(170,852)	38,702
Changes in Assets and Liabilities, net of acquisition:			
Losses and loss expenses	23,363,781	12,296,118	7,452,899
Unearned premiums	14,138,883	7,788,243	2,395,965
Accrued expenses	1,308,632	(165,997)	1,166,287
Premiums receivable	(2,385,029)	(3,296,815)	1,477,671
Deferred policy acquisition costs	(1,320,001)	(316,463)	64,545
Deferred income taxes	(1,360,633)	499,976	(3,783,354)
Reinsurance receivable	(13,309,290)	(8,970,330)	(3,809,600)
Accrued investment income	237,388	(455,059)	(311,975)
Amounts due to/from affiliate	(513,922)	350,639	(1,133,037)
Reinsurance balances payable	(795,819)	262,686	(499,423)
Prepaid reinsurance premiums	(4,881,083)	(3,156,232)	(4,041,033)
Current income taxes	(32,656)	374,620	(388,577)
Change in pooling participation	—	3,322,031	—
Other, net	(271,364)	268,316	508,807
Net adjustments	16,186,651	9,613,807	216,471
Net cash provided by operating activities	22,004,782	18,450,587	7,011,668
Cash Flows from Investing Activities:			
Purchase of fixed maturities			
Held to maturity	(45,201,470)	(17,340,175)	(23,782,305)
Available for sale	(71,700,918)	(30,355,507)	(32,890,963)
Purchase of equity securities	(12,440,994)	(28,286,533)	(14,258,861)
Sale of fixed maturities			
Available for sale	16,250,109	8,719,165	503,895
Maturity of fixed maturities			
Held to maturity	51,313,296	13,490,715	15,563,638
Available for sale	50,781,533	11,928,622	19,049,880
Sale of equity securities	7,089,532	24,572,288	11,767,268
Sale of Atlantic Insurance Services, net	—	—	(48,810)
Net purchase of property and equipment	(161,269)	(275,982)	(461,669)
Net sales (purchases) of short-term investments	(4,634,695)	(2,850,343)	14,619,107
Net cash used in investing activities	(8,704,876)	(20,397,750)	(9,938,820)
Cash Flows from Financing Activities:			
Issuance of common stock	1,386,746	2,756,540	2,514,415
Borrowings (payments) under line of credit, net	(12,400,000)	3,000,000	(500,000)
Cash dividends paid	(3,394,352)	(3,126,959)	(2,946,170)
Net cash provided by (used in) financing activities	(14,407,606)	2,629,581	(931,755)
Net increase (decrease) in cash	(1,107,700)	682,418	(3,858,907)
Cash at beginning of year	5,182,988	4,500,570	8,359,477
Cash at end of year	$ 4,075,288	$ 5,182,988	$ 4,500,570

*Restated - see note 1

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1—Summary of Significant Accounting Policies

Organization and Business

Donegal Group Inc. (the "Company") was organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") and operates in the Mid-Atlantic and Southern states through its wholly owned stock insurance companies, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Southern Heritage Insurance Company ("Southern Heritage") and Pioneer Insurance Company of Ohio ("Pioneer-Ohio") (collectively "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 70% of the pooled business (65% prior to July 1, 2000). Southern cedes 50% of its business to the Mutual Company. At December 31, 2001, the Mutual Company held 63% of the outstanding common stock of the Company.

In addition to the Company's Insurance Subsidiaries, it also owned all of the outstanding stock of Atlantic Insurance Services, Inc. ("AIS"), an insurance services organization. The Company sold all of the stock of AIS on October 1, 1999.

During 2000, the Company acquired 45% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a bank holding company, for $3,042,000 in cash. The remaining 55% of the outstanding stock of DFSC is owned by the Mutual Company.

On January 3, 2001, the Company announced that it had purchased all of the outstanding stock of Pioneer Insurance Company of New York ("Pioneer-New York") from the Mutual Company effective January 1, 2001. The purchase price was $4,441,311, representing Pioneer-New York's adjusted statutory equity at December 31, 2000. The acquisition has been accounted for as a reorganization of entities under common control, similar to a pooling of interests, as both Pioneer-New York and the Company are under the common management and control of the Mutual Company. As such, the Company's financial statements have been restated to include Pioneer-New York as a consolidated subsidiary. In connection with the transaction, the Company issued the Mutual Company a $4,441,311 note, which bears a 6% rate and is due in January 2003. The Company classifies this note in Due to Affiliate.

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

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 the accounts of Donegal Group Inc. and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The term "Company" as used herein refers to the consolidated entity.

Use of Estimates

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

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

Investments

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

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

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

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

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

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

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

Fair Values of Financial Instruments

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

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

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

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

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

Revenue Recognition

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

Policy Acquisition Costs

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

Property and Equipment

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

Losses and Loss Expenses

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

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

The Company has no material exposures to environmental liabilities.

Income Taxes

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

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

Credit Risk

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

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

Reinsurance Accounting and Reporting

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

Stock-Based Compensation

Effective July 1, 2000, the Company adopted Financial Accounting Standards Board 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 Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and FIN No. 44, Accounting for Certain Transactions involving Stock Compensation." FIN No. 44 states that 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 that fair value as a dividend to the controlling entity. These provisions apply to the Company, as the Mutual Company is the employer of record for all employees that provide services to the Company.

Prior to July 1, 2000, the Company's stock-based compensation plans were accounted for under the provisions of APB Opinion No. 25 and related interpretations. As such, compensation expense was recorded on the date of stock option grant only if the current market price of the underlying stock exceeded the exercise price. Additionally, the Company provides the pro-forma net income and earnings per share disclosures required by Statement of Financial Accounting Standards (SFAS No. 123), "Accounting for Stock-Based Compensation," for grants prior to the adoption of FIN No. 44.

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.

Reclassifications

Certain amounts in these financial statements have been reclassified from those previously presented. Gross and ceded premiums earned and losses and loss expenses are no longer presented in the statements of income. Reinsurance receivable, prepaid reinsurance premiums, unearned premiums, and the liabilities for losses and loss expenses have been reduced in the consolidated balance sheet as they no longer include the amounts under the agreements discussed in the last paragraph of note 2a. The amounts in note 6 as well as the consolidated statements of cash flows have been revised to conform to the changes in the consolidated balance sheets. Note 2a has been expanded to include the purpose of the various agreements and to separately disclose amounts under the various arrangements versus the aggregate disclosure previously provided. These reclassifications had no effect on total revenues, total expenses, net income, net income per share, cash flows provided by operating activities, or stockholders' equity.

2—Transactions with Affiliates

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

a. Reinsurance Pooling and Other Reinsurance Arrangements

Atlantic States cedes to the Mutual Company all of its insurance business and assumes from the Mutual Company 70% (65% prior to July 1, 2000) of the Mutual Company's total pooled insurance business, including that assumed from Atlantic States and substantially all of the business assumed by the Mutual Company from Southern and Delaware (prior to January 1, 2000). The Mutual Company and Atlantic States write business with different risk profiles. Through the pooling arrangement, each is able to share proportionately in the results of all policies written by the other. Atlantic States ceded premiums earned of $37,345,259, $30,414,395 and $23,745,989 and ceded losses and loss expenses incurred of $29,094,804, $22,966,106 and $15,625,894 under this arrangement during 2001, 2000 and 1999, respectively. It also assumed premiums earned of $126,769,521, $110,943,962 and $101,017,767 and assumed losses and loss expenses incurred of $93,470,958, $75,007,089 and $68,563,183 under this arrangement during 2001, 2000 and 1999, respectively. Atlantic States had prepaid reinsurance premiums of $20,942,093, $16,251,612 and $12,978,863 and a ceded liability for losses and loss expenses of $39,321,214, $31,068,101 and $24,025,502 under this arrangement as of December 31, 2001, 2000 and 1999, respectively. It also had assumed unearned premiums of $63,636,858, $54,578,621 and $46,283,485 and an assumed liability for losses and loss expenses of $99,664,285, $84,805,937 and $80,258,589 under this arrangement at December 31, 2001, 2000 and 1999, respectively.

The Mutual Company and Southern have a quota share agreement whereby Southern cedes 50% of its direct business, less reinsurance, to the Mutual Company. The business assumed by the Mutual Company from Southern becomes part of the pooling arrangement between the Mutual Company and Atlantic States. Southern ceded premiums earned of $14,995,606, $14,413,261 and $13,517,603 and ceded losses and loss expenses incurred of $9,898,422, $9,885,436 and $9,986,718 under this agreement during 2001, 2000 and 1999, respectively. Southern had prepaid reinsurance premiums of $7,310,471, $7,084,729 and $6,683,001 and a ceded liability for losses and loss expenses of $10,068,604, $7,924,750 and $7,054,012 under this agreement at December 31, 2001, 2000 and 1999, respectively. This agreement was terminated as of January 1, 2002.

Atlantic States, Southern, Pioneer-Ohio and Southern Heritage each have a catastrophe reinsurance agreement with the Mutual Company which limits the maximum liability under any one catastrophic occurrence to $400,000, $300,000, $200,000 and $400,000 (effective January 1, 2000), respectively, and $1,000,000 ($700,000 in 1999) for a catastrophe involving more than one of the companies. Prior to merging into Atlantic States, Delaware and Pioneer-New York each had a catastrophe reinsurance agreement with the Mutual Company which limited the maximum liability under any one catastrophic occurrence to $300,000 and $400,000, respectively. Prior to merging into Atlantic States, Delaware and the Mutual Company had an excess of loss reinsurance agreement in which the Mutual Company assumed up to $250,000 of losses in excess of $50,000 and prior to January 1, 2000, a workers' compensation quota share agreement whereby Delaware ceded 70% of that business. The Mutual Company and Pioneer-Ohio have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $250,000 ($200,000 in 2000 and 1999) of losses in excess of $50,000. The Mutual Company and Southern have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $50,000 ($25,000 in 2000 and 1999) of losses in excess of $100,000. Prior to merging into Atlantic States, Pioneer-New York and the Mutual Company had an excess of loss reinsurance agreement in which the Mutual Company assumed up to $250,000 ($200,000 in 2000 and 1999) of losses in excess of $50,000. Effective October 1, 2000 the Mutual Company and Southern Heritage have an excess of loss reinsurance agreement in which the Mutual Company assumed up to $175,000 ($125,000 in 2000) of losses in excess of $125,000. The Mutual Company has agreements in place with Southern and Pioneer-Ohio (and Delaware prior to merging into Atlantic States) to reallocate the loss results of workers' compensation business written by those companies as part of commercial accounts primarily written by the Mutual Company or Atlantic States. These agreements provide for the workers' compensation loss ratios of each company to be no worse than the average workers' compensation loss ratio for all of the companies combined. The Mutual Company and Pioneer-New York also had an aggregate excess of loss reinsurance agreement, entered into as part of the sale of Pioneer-New York from the Mutual Company to Donegal Group Inc., in which the Mutual Company agreed to assume the adverse loss development of claims with dates of loss prior to December 31, 2000, as developed through December 31, 2002, and to assume losses in excess of a 60% loss ratio through December 31, 2002. The subsidiaries ceded premiums earned of $2,439,520, $2,126,882 and $3,519,914 and ceded losses and loss expenses incurred of $4,194,251, $5,388,111 and $4,400,776 under these various agreements during 2001, 2000 and 1999, respectively. The subsidiaries had prepaid reinsurance premiums of $0, $0 and $733,183 and a ceded liability for losses and loss expenses of $5,395,528, $4,941,116 and $2,689,825 under these various agreements at December 31, 2001, 2000, and 1999, respectively.

Southern, Pioneer-Ohio and Southern Heritage (and Delaware and Pioneer-New York prior to merging into Atlantic States) each 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 the agreements is to provide these subsidiaries with the same A.M. Best rating (currently "A") as the Mutual Company, which these subsidiaries could not achieve without these contracts in place. These agreements do not transfer insurance risk. While these subsidiaries ceded and reassumed amounts received from policyholders of $41,142,936, $25,790,126 and $22,486,490 and claims of $23,348,952, $15,325,638 and $13,177,186 under these agreements in 2001, 2000 and 1999, respectively, the amounts are not reflected in the consolidated financial statements. The aggregate liabilities ceded and reassumed under these agreements were $36,494,487 and $26,572,959 at December 31, 2001, and 2000, respectively.

b. Expense Sharing

The Mutual Company provides facilities, management and other services to the Company, and the Company reimburses the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of the Company and the Mutual Company in the pooling arrangement, and management of both the Company and the Mutual Company consider this allocation to be reasonable. Charges for these services totalled $29,298,569, $26,985,080 and $27,466,898 for 2001, 2000 and 1999, respectively.

c. Lease Agreement

The Company leases office equipment and automobiles to the Mutual Company under a 10-year lease dated January 1, 2000.

d. Legal Services

Donald H. Nikolaus, President and a director of the Company, is also a partner in the law firm of Nikolaus & Hohenadel. Such firm has served as general counsel to the Company 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, 2001, the Company had $3,585,566 in checking accounts with Province Bank, a wholly owned subsidiary of DFSC. The Company earned $6,350 in interest on these accounts during 2001.

3—Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2001 and 2000, are as follows:

	2001			
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	$ 23,808,841	$ 336,288	$ 27,500	$ 24,117,629
Canadian government obligation	498,894	36,106	—	535,000
Obligations of states and political subdivisions	24,981,562	690,700	53,312	25,618,950
Corporate securities	27,423,039	659,961	121,021	27,961,979
Mortgage-backed securities	8,610,629	113,541	18,335	8,705,835
Totals	$ 85,322,965	$1,836,596	$ 220,168	$ 86,939,393

Available for Sale	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		2001		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 67,468,897	$1,755,874	$ 249,306	$ 68,975,465
Obligations of states and political subdivisions	53,962,895	1,269,340	85,535	55,146,700
Corporate securities	34,094,195	828,344	115,939	34,806,600
Mortgage-backed securities	14,743,597	78,666	32,184	14,790,079
Equity securities	16,630,618	1,270,239	383,511	17,517,346
Totals	$186,900,202	$5,202,463	$866,475	$191,236,190

Held to Maturity	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		2000		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 38,779,230	$ 343,819	$ 255,049	$ 38,868,000
Canadian government obligation	498,559	11,441	—	510,000
Obligations of states and political subdivisions	66,831,090	1,499,955	45,904	68,285,141
Corporate securities	21,621,472	228,851	195,287	21,655,036
Mortgage-backed securities	15,451,367	47,120	154,228	15,344,259
Totals	$143,181,718	$2,131,186	$ 650,468	$144,662,436

Available for Sale	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		2000		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 68,007,634	$ 544,135	$ 650,339	$ 67,901,430
Obligations of states and political subdivisions	17,965,179	327,256	36,885	18,255,550
Corporate securities	22,902,588	312,426	306,664	22,908,350
Mortgage-backed securities	5,649,071	14,790	118,008	5,545,853
Equity securities	12,500,558	880,419	1,268,741	12,112,236
Totals	$127,025,030	$2,079,026	$2,380,637	$126,723,419

The amortized cost and estimated fair value of fixed maturities at December 31, 2001, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
Held to maturity		
Due in one year or less	$ 1,000,081	$ 1,012,500
Due after one year through five years	33,277,659	33,857,210
Due after five years through ten years	38,671,342	39,626,349
Due after ten years	3,763,254	3,737,500
Mortgage-backed securities	8,610,629	8,705,834
Total held to maturity	$ 85,322,965	$ 86,939,393
Available for sale		
Due in one year or less	$ 11,815,944	$ 12,046,000
Due after one year through five years	79,085,686	81,151,668
Due after five years through ten years	56,670,691	57,971,097
Due after ten years	7,953,666	7,760,000
Mortgage-backed securities	14,743,597	14,790,079
Total available for sale	$170,269,584	$173,718,844

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2001 and 2000, amounted to $5,667,959 and $6,056,374, respectively.

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

	2001	2000	1999
Fixed maturities	$15,145,949	$15,180,008	$13,046,603
Equity securities	546,243	635,049	440,268
Short-term investments	920,538	1,221,724	809,949
Other	255,250	255,250	316,139
Investment income	16,867,980	17,292,031	14,612,959
Investment expenses	982,436	897,284	1,022,264
Net investment income	$15,885,544	$16,394,747	$13,590,695

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:

	2001	2000	1999
Gross realized gains:			
Fixed maturities	$ 554,560	$ 237,748	$ —
Equity securities	323,451	1,813,242	586,745
	878,011	2,050,990	586,745
Gross realized losses:			
Fixed maturities	28,618	20,597	6,083
Equity securities	1,729,647	1,859,541	619,364
	1,758,265	1,880,138	625,447
Net realized gains (losses)	$(880,254)	$ 170,852	$ (38,702)
Change in difference between fair value and cost of investments:			
Fixed maturities	$ 3,498,259	$ 7,300,279	$(11,668,991)
Equity securities	1,275,050	(603,930)	(362,312)
	$ 4,773,309	$ 6,696,349	$(12,031,303)

Income taxes (benefit) on realized investment gains (losses) were $(299,286), $58,090, and $(13,159) for 2001, 2000 and 1999, respectively. Deferred income taxes (benefits) applicable to net unrealized investment gains (losses) included in shareholders' equity were $1,474,242 and $(102,548) at December 31, 2001 and 2000, respectively.

During 2001 and 2000, certain investments trading below cost had declined on an other-than-temporary basis. Losses of $1,462,913 and $436,943 were included in net realized investment gains (losses) for these investments in 2001 and 2000, respectively.

The Company has no derivative instruments or hedging activities. On January 1, 2001, the Company transferred investments with an amortized cost of $51,640,154 and fair value of $52,444,675 from the held to maturity classification to the available for sale classification under the provisions of SFAS No. 133 and 138. The unrealized holding gain of $804,521 at January 1, 2001 was reported in other comprehensive income. The transfer had no impact on net income.

4—Deferred Policy Acquisition Costs

Changes in deferred policy acquisition costs are as follows:

	2001	2000	1999
Balance, January 1	$12,284,214	$ 11,445,572	$ 11,510,117
Acquisition costs deferred	28,514,001	26,157,642	24,866,455
Amortization charged to earnings	27,194,000	25,319,000	24,931,000
Balance, December 31	$13,604,215	$ 12,284,214	$ 11,445,572

5—Property and Equipment

Property and equipment at December 31, 2001 and 2000, consisted of the following:

	2001	2000	Estimated Useful Life
Cost—office equipment	$5,012,290	$4,981,970	5-15 years
automobiles	992,412	947,865	3 years
real estate	3,063,646	3,063,646	15-50 years
software	561,146	561,146	5 years
	9,629,494	9,554,627	
Accumulated depreciation	(5,060,842)	(4,318,144)	
	$4,568,652	$5,236,483	

Depreciation expense for 2001, 2000, and 1999 amounted to $829,100, $899,750 and $970,331, respectively.

6—Liability for Losses and Loss Expenses

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

	2001	2000	1999
Balance at January 1	$156,476,124	$144,180,006	$136,727,107
Less reinsurance recoverable	53,766,710	44,945,908	40,712,330
Net balance at January 1	102,709,414	99,234,098	96,014,777
Incurred related to:			
Current year	110,142,467	103,671,401	100,573,192
Prior years	8,035,082	711,775	(492,576)
Total incurred	118,177,549	104,383,176	100,080,616
Paid related to:			
Current year	63,289,736	61,848,261	59,434,306
Prior years	43,053,112	39,059,599	37,426,989
Total paid	106,342,848	100,907,860	96,861,295
Net balance at December 31	114,544,115	102,709,414	99,234,098
Plus reinsurance recoverable	65,295,790	53,766,710	44,945,908
Balance at December 31	$179,839,905	$156,476,124	$144,180,006

The Company recognized an increase (decrease) in the liability for losses and loss expenses of prior years of $8.0 million, $0.7 million and $(0.5 million) in 2001, 2000 and 1999, respectively. These developments are primarily attributable to variations from expected claim severity in the private passenger and commercial automobile liability, workers' compensation and commercial multiple peril lines of business.

7—Line of Credit

At December 31, 2001 and 2000, pursuant to a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank, the Company had unsecured borrowings of $27.6 million and $40 million, respectively. Such borrowings were made in connection with the acquisitions of Delaware, Pioneer-Ohio, and Southern Heritage and various capital contributions to the subsidiaries. As of December 31, 2001, the Company may borrow up to $32 million at interest rates equal to the bank's then current prime rate or the then current London interbank Eurodollar bank rate plus 1.70%. At December 31, 2001, the interest rates were 4.75% on an outstanding prime rate balance of $2.6 million, 3.825% on an outstanding Eurodollar rate balance of $10 million and 3.6375% on another Eurodollar rate balance of $15 million. In addition, the Company pays a rate of 3/10 of 1% per annum on the average daily unused portion of the bank's commitment. On each July 27, the credit line is reduced by $8 million. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

8—Reinsurers

Unaffiliated Reinsurers

In addition to the primary reinsurance in place with the Mutual Company, the Insurance Subsidiaries have other reinsurance in place, principally with four unaffiliated reinsurers. The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers during 2001, 2000 and 1999:

	2001	2000	1999
Premiums written	$ 9,348,853	$ 8,241,416	$ 8,391,805
Premiums earned	$ 9,440,035	$ 8,026,478	$ 8,549,509
Losses and loss expenses	$ 6,907,947	$ 3,027,810	$ 5,537,410
Prepaid reinsurance premiums	$ 1,340,903	$ 1,376,043	$ 1,161,105
Liability for losses and loss expenses	$10,510,444	$ 9,832,743	$11,176,569

Total Reinsurance

The following amounts represent the total of all ceded reinsurance transactions with both affiliated and unaffiliated reinsurers during 2001, 2000, and 1999:

	2001	2000	1999
Premiums earned	$64,220,420	$54,981,016	$49,333,015
Losses and loss expenses	$50,095,424	$41,267,463	$35,550,798
Prepaid reinsurance premiums	$29,593,467	$24,712,384	$21,556,152
Liability for losses and loss expenses	$65,295,790	$53,766,710	$44,945,908

The following amounts represent the effect of reinsurance on premiums written for 2001, 2000, and 1999:

	2001	2000	1999
Direct	$110,298,533	$ 99,042,235	$ 91,854,011
Assumed	135,830,624	119,217,433	105,392,426
Ceded	69,101,503	58,137,248	53,374,048
Net premiums written	$177,027,654	$160,122,420	$143,872,389

The following amounts represent the effect of reinsurance on premiums earned for 2001, 2000, and 1999:

	2001	2000	1999
Direct	$105,214,059	$ 95,671,588	$ 93,399,834
Assumed	126,776,215	110,955,627	101,450,638
Ceded	64,220,420	54,981,016	49,333,015
Net premiums earned	$167,769,854	$151,646,199	$145,517,457

9—Income Taxes

The provision for income tax consists of the following:

	2001	2000	1999
Current	$2,634,231	$ 2,406,272	$ 832,798
Deferred	(1,360,633)	499,976	(3,783,354)
Federal tax provision	$1,273,598	$ 2,906,248	$(2,950,556)

The effective tax rate is different than the amount computed at the statutory federal rate of 34% for 2001, 2000 and 1999. The reason for such difference and the related tax effect are as follows:

	2001	2000	1999
Income before income taxes	$7,091,729	$11,743,028	$ 3,844,641
Computed "expected" taxes at 34%	2,411,188	3,992,630	1,307,178
Recognition of net operating loss carryover of Southern Heritage	—	—	(3,004,524)
Tax-exempt interest	(1,399,238)	(1,347,959)	(1,355,816)
Dividends received deduction	(21,908)	(25,423)	(83,948)
Other, net	283,556	287,000	186,554
Federal income tax provision	$1,273,598	$ 2,906,248	$(2,950,556)

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2001 and 2000, are as follows:

	2001	2000
Deferred tax assets:		
Unearned premium	$ 5,778,529	$ 5,139,217
Loss reserves	5,433,005	4,878,850
Net operating loss carryforward - Southern Heritage	2,032,094	2,339,133
Unrealized loss	—	102,548
Other	1,013,899	174,886
Total	$14,257,527	$12,634,634
Deferred tax liabilities:		
Depreciation expense	$ 379,594	$ 464,235
Deferred policy acquisition costs	4,625,433	4,176,632
Salvage recoverable	303,528	302,881
Unrealized gain	1,474,242	—
Total	$ 6,782,797	$ 4,943,748
Net deferred tax assets	$ 7,474,730	$ 7,690,886

A valuation allowance is provided when it is more likely than not that some portion of the tax asset will not be realized. Management has determined that it is not required to establish a valuation allowance for any deferred tax asset at December 31, 2001, since it is more likely than not that the deferred tax assets will be realized through reversals of existing temporary differences, future taxable income, carryback to taxable income in prior years and the implementation of tax planning strategies.

A change in the federal income laws was enacted during 1999 which allows net operating loss carryforwards of an acquired company to be used to offset future taxable income of other affiliated companies filing as part of a consolidated tax return. Prior law allowed such net operating loss carryforward to be used to offset taxable income of the acquired company only. Due to this law change, the net operating loss carryforward, obtained as part of the acquisition of Southern Heritage, can now be used to offset taxable income generated by the other consolidated affiliates. This was the primary factor in management's determination that no valuation allowance was required at the end of 1999. Accordingly, the tax benefit of this carryforward, as adjusted for the 1998 tax return as filed, of $3,004,524 was recognized in 1999.

At December 31, 2001, the Company has a net operating loss carryforward of $5,976,747, which is available to offset taxable income of the Company. Such net operating loss carryforward will expire beginning in 2009. Federal income tax laws limit the amount of net operating loss carryforward that the Company can use in any one year to approximately $1 million.

10—Stockholders' Equity

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

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

11—Stock Compensation Plans

Equity Incentive Plans

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

During 1996 the Company adopted an Equity Incentive Plan For Directors. During 2001 the Company adopted a nearly identical plan that made 200,000 shares of Class A common stock available. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 175 shares of restricted stock to each director on the first business day of January in each year. As of December 31, 2001, the Company has 76,112 unexercised options under these plans. Additionally 1,947, 1,947 and 2,124 shares of restricted stock were issued on January 2, 2001, 2000 and 1999, respectively.

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

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

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 1998	1,091,120	$15.73
Granted – 1999	433,500	8.00
Exercised – 1999	—	—
Forfeited – 1999	28,227	15.52
Outstanding at December 31, 1999	1,496,393	$13.50
Granted – 2000	59,500	8.05
Exercised – 2000	—	—
Forfeited – 2000	39,555	12.84
Outstanding at December 31, 2000	1,516,338	$13.19
Granted – 2001	459,000	13.93
Exercised – 2001	13,315	8.00
Forfeited – 2001	27,556	13.50
Outstanding at December 31, 2001	1,934,467	$13.27
Exercisable at:		
December 31, 1999	897,338	$15.99
December 31, 2000	1,190,004	$16.68
December 31, 2001	1,321,905	$13.89

Options available for future grants at December 31, 2001 are 1,241,000.

The following table summarizes information about fixed stock options at December 31, 2001:

Exercise Price	Number of Options Outstanding	Weighted-Average Remaining Contractual Life	Number of Options Exercisable
$ 8.00	457,685	3.0 years	305,123
$ 9.00	9,500	4.5 years	2,000
$13.50	524,448	0.1 years	524,448
$14.00	452,500	4.5 years	—
$18.00	490,334	1.25 years	490,334

Employee Stock Purchase Plans

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

The new plan extends over a 10-year period and provides for shares to be offered to all eligible employees at a purchase price equal to the lesser of 85% of the fair market value of the Company's 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 the Company's 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, 1999	$13.28125	10,227
July 1, 1999	$ 9.66875	11,876
January 1, 2000	$ 5.41875	23,906
July 1, 2000	$ 4.88750	21,714
January 1, 2001	$ 5.95000	16,438
July 1, 2001	$ 8.71250	11,377

On January 1, 2002, the Company issued an additional 12,769 shares at a price of $8.84850 per share under this plan.

Agency Stock Purchase Plans

On December 31, 1996, the Company adopted an Agency Stock Purchase Plan. During 2001, the Company adopted a nearly identical plan that made 300,000 shares of Class A common stock available for issuance. The plan provides for agents of affiliated companies of Donegal Group Inc. to invest up to $12,000 per subscription period (April 1 to September 30 and October 1 to March 31) under various methods. Stock is issued at the end of the subscription period at a price equal to 90% of the average market price during the last ten trading days of the subscription period. During 2001, 2000 and 1999, 16,557, 46,603, and 47,841 shares, respectively, were issued under this plan. Expense recognized under the plan was not material.

Pro-forma Disclosures

The weighted-average grant date fair value of options granted for the various plans during 2000 and 1999 was $2.23 and $1.98, respectively.

The fair values above were calculated based upon risk-free interest rates of 5.75% for the Stock Purchase Plans and the Equity Incentive Plans, expected lives of 6 months for the Stock Purchase Plans and 5 years for the Equity Incentive Plans, expected volatility of 54% for 2000 and 47% for 1999, and an expected dividend yield of 4.5% for 2000 and 5.0% for 1999.

Through June 30, 2000, the Company applied APB Opinion No. 25 in accounting for its stock-based compensation plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and certain of its stock purchase plans. Had the Company recognized stock compensation expense in accordance with SFAS No. 123, net income and earnings per share would have been reduced to the pro-forma amounts shown below:

	2001	2000	1999
Net income:			
As reported	$5,818,131	$8,836,780	$6,795,197
Pro-forma	5,617,773	8,071,825	5,595,851
Basic earnings per share:			
As reported	.65	1.01	.82
Pro-forma	.63	.92	.68
Diluted earnings per share:			
As reported	.64	1.01	.82
Pro-forma	.62	.92	.68

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

The following is selected information, as filed with insurance regulatory authorities, for the Insurance Subsidiaries as determined in accordance with accounting practices prescribed or permitted by such insurance regulatory authorities (restated for mergers):

	2001	2000	1999
Atlantic States			
Statutory capital and surplus	$ 86,124,896	$ 88,620,380	$ 82,401,227
Statutory unassigned surplus	$ 44,464,032	$ 46,959,516	$ 40,740,363
Statutory net income (loss)	$ (54,605)	$ 8,134,135	$ 4,832,737
Southern			
Statutory capital and surplus	$ 10,863,481	$ 9,082,587	$ 7,293,856
Statutory unassigned surplus	$ 5,761,211	$ 3,980,317	$ 2,191,586
Statutory net income	$ 1,666,477	$ 1,543,128	$ 184,285
Pioneer-Ohio			
Statutory capital and surplus	$ 5,524,466	$ 5,811,315	$ 5,677,926
Statutory unassigned deficit	$ (1,475,534)	$ (1,188,685)	$ (1,322,074)
Statutory net income	$ (621,520)	$ (176,011)	$ 108,322
Southern Heritage			
Statutory capital and surplus	$ 19,867,276	$ 16,975,171	$ 16,508,422
Statutory unassigned deficit	$(12,648,039)	$(15,540,144)	$(16,006,893)
Statutory net income	$ 3,514,487	$ 1,486,698	$ 487,098

The Company's principal source of cash for payment of dividends are dividends from its Insurance Subsidiaries which are required by law to maintain certain minimum capital and surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States, Southern, Pioneer-Ohio and Southern Heritage are also subject to Risk Based Capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 2001, all four companies' statutory capital and surplus were substantially above the RBC requirements. Amounts available for distribution as dividends to Donegal Group Inc. without prior approval of insurance regulatory authorities in 2002 are $8,612,490 from Atlantic States, $1,086,348 from Southern, $552,447 from Pioneer-Ohio and $3,514,487 from Southern Heritage.

The National Association of Insurance Commissioners (NAIC) has adopted the Codification of Statutory Accounting Principles with an effective date of January 1, 2001. The codified principles are intended to provide a basis of accounting recognized and adhered to in the absence of conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the statutory capital and surplus of the Company's Insurance Subsidiaries as of January 1, 2001 is as follows: Atlantic States - $6,168,742 increase; Southern Heritage - $1,083,354 increase; Pioneer-Ohio - $313,638 increase; and Southern - $1,171,204 increase.

13—Reconciliation of Statutory Filings to Amounts Reported Herein

The Company's Insurance Subsidiaries are required to file statutory financial statements with state insurance regulatory authorities. Accounting principles used to prepare these statutory financial statements differ from financial statements prepared on the basis of generally accepted accounting principles.

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

	Year Ended December 31,		
	2001	2000	1999
Statutory net income of Insurance Subsidiaries	$4,504,839	$10,987,950	$5,612,442
Increases (decreases):			
Deferred policy acquisition costs	1,320,001	838,642	(64,545)
Deferred federal income taxes	1,360,633	(499,976)	3,783,354
Salvage and subrogation recoverable	155,088	305,918	(226,617)
Consolidating eliminations and adjustments	(13,783,695)	(4,318,624)	(1,387,864)
Parent-only net income (loss)	12,261,265	1,522,870	(908,987)
Non-insurance subsidiary net income (loss)	—	—	(12,586)
Net income as reported herein	$5,818,131	$ 8,836,780	$6,795,197

	December 31,		
	2001	2000	1999
Statutory capital and surplus of Insurance Subsidiaries	$122,380,119	$120,489,453	$111,881,431
Increases (decreases):			
Deferred policy acquisition costs	13,604,215	12,284,214	11,445,572
Deferred federal income taxes	(820,313)	7,690,886	9,221,874
Salvage and subrogation recoverable	8,197,948	8,042,860	7,736,942
Statutory reserves	—	2,623,921	5,154,062
Non-admitted assets and other adjustments, net	334,092	911,370	942,170
Fixed maturities	3,793,048	493,055	(2,968,655)
Consolidating eliminations and adjustments	(39,693,089)	(40,973,097)	(41,072,150)
Parent-only equity	13,132,329	2,566,929	1,451,088
Stockholders' equity as reported herein	$120,928,349	$114,129,591	$103,792,334

14—Supplementary Information on Statement of Cash Flows

The following reflects income taxes and interest paid during 2001, 2000 and 1999:

	2001	2000	1999
Income taxes	$2,666,887	$ 2,031,652	$ 1,221,375
Interest	$3,049,844	$ 2,731,048	$ 1,370,155

During 1999, the Company wrote off fixed assets with a net carrying value of $407,000 which was a non-cash charge to earnings.

15—Earnings Per Share

The following information illustrates the computation of net income, outstanding shares and earnings per share on both a basic and diluted basis for the years ending December 31, 2001, 2000 and 1999:

	Net Income	Weighted-Average Shares Outstanding	Earnings Per Share
2001:			
Basic	$5,818,131	8,941,781	.65
Effect of stock options	—	136,669	(.01)
Diluted	$5,818,131	9,078,450	.64
2000:			
Basic	$ 8,836,780	8,715,899	$1.01
Effect of stock options	—	21,011	—
Diluted	$ 8,836,780	8,736,910	$1.01
1999:			
Basic	$ 6,795,197	8,327,356	$ .82
Effect of stock options	—	—	—
Diluted	$ 6,795,197	8,327,356	$ .82

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:

	2001	2000	1999
Options excluded from diluted earnings per share	1,467,282	1,045,338	1,496,393

16—Condensed Financial Information of Parent Company

Condensed Balance Sheets

($ in thousands)

December 31,	2001	2000
Assets		
Investment in subsidiaries (equity method)	$152,089	$155,600
Cash	403	2,381
Property and equipment	1,623	1,997
Other	264	715
Total assets	$154,379	$160,693
Liabilities and Stockholders' Equity		
Liabilities		
Cash dividends declared to stockholders	$ 870	$ 797
Line of credit	27,600	40,000
Due to affiliate	4,441	4,441
Other	540	1,325
Total liabilities	33,451	46,563
Stockholders' equity	120,928	114,130
Total liabilities and stockholders' equity	$154,379	$160,693

Condensed Statements of Income

($ in thousands)

Year Ended December 31,	2001	2000	1999
Revenues			
Dividends-subsidiaries	$14,419	$ 3,900	$ 820
Other	824	866	865
Total revenues	15,243	4,766	1,685
Expenses			
Operating expenses	1,761	1,165	938
Interest	2,288	3,304	2,463
Total expenses	4,049	4,469	3,401
Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries	11,194	297	(1,716)
Income tax benefit	(1,067)	(1,226)	(807)
Income (loss) before equity in undistributed net income (loss) of subsidiaries	12,261	1,523	(909)
Equity in undistributed net income (loss) of subsidiaries	(6,443)	7,314	7,704
Net income	$5,818	$ 8,837	$ 6,795

Condensed Statements of Cash Flows

($ in thousands)

Year Ended December 31,	2001	2000	1999
Cash flows from operating activities:			
Net income	$ 5,818	$ 8,837	$ 6,795
Adjustments:			
Equity in undistributed net loss (income) of subsidiaries	6,443	(7,314)	(7,704)
Other	252	1,123	2,365
Net adjustments	6,695	(6,191)	(5,339)
Net cash provided	12,513	2,646	1,456
Cash flows from investing activities:			
Net purchase of property and equipment	(122)	(262)	(426)
Sale of AIS	—	—	100
Investment in Donegal Financial Services Corp.	—	(3,042)	—
Other	38	38	(426)
Net cash used	(84)	(3,266)	(752)
Cash flows from financing activities:			
Cash dividends paid	(3,394)	(3,127)	(2,946)
Issuance of common stock	1,387	2,757	2,514
Line of credit, net	(12,400)	3,000	(500)
Net cash provided (used)	(14,407)	2,630	(932)
Net change in cash	(1,978)	2,010	(228)
Cash at beginning of year	2,381	371	599
Cash at end of year	$ 403	$ 2,381	$ 371

17—Segment Information

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

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

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

Financial data by segment is as follows:

	2001	2000	1999
		($ in thousands)	
Revenues:			
Premiums earned:			
Commercial lines	$ 62,877	$ 54,581	$ 47,804
Personal lines	104,893	97,065	97,713
Total premiums earned	167,770	151,646	145,517
Net investment income	15,886	16,395	13,591
Realized investment gains (losses)	(880)	171	(39)
Other	2,388	2,370	2,670
Total revenues	$185,164	$170,582	$161,739
Income before income taxes:			
Underwriting income (loss):			
Commercial lines	$ (3,037)	$ 763	$ (839)
Personal lines	(5,090)	(4,649)	(8,461)
SAP underwriting loss	(8,127)	(3,886)	(9,300)
GAAP adjustments	1,833	1,144	(184)
GAAP underwriting loss	(6,294)	(2,742)	(9,484)
Net investment income	15,886	16,395	13,591
Realized investment gains (losses)	(880)	171	(39)
Other	(1,620)	(2,081)	(223)
Income before income taxes	$ 7,092	$ 11,743	$ 3,845

18—Restructuring Charge

On September 29, 1999, the Company announced a plan to consolidate certain subsidiary support functions into its Marietta, Pennsylvania office. As a result of this consolidation, the Company recorded a restructuring charge of $2,206,000 in 1999 for employee termination benefits, occupancy charges, lease cancellation costs, and asset impairments. The charge was included in other underwriting expenses. The consolidation was completed by the end of the first quarter of 2000.

Employee termination benefits of $782,000 included severance payments, which were paid in a lump sum or over a defined period, and related benefits for approximately 60 employees. Of the terminated employees, approximately 50% were from subsidiary support functions and approximately 50% were from the Marietta, Pennsylvania office. By December 31, 1999, all of the terminated employees had left the employment of the Company.

Included in occupancy charges of $488,000 were future lease obligations, less anticipated sublease benefits, for leased space which is no longer used by the Delaware and Southern Heritage subsidiary support functions.

Also included in the restructuring charge was $529,000 related to contract cancellation costs that represented the estimated cost to buy out of the remaining term on printer, copier, and computer processing contracts that provided no future benefit to the Company as a result of the restructuring. All such assets have been taken out of service.

Asset impairments, which were a direct result of the consolidation of subsidiary functions, amounted to $407,000. They consisted of capitalized programming and data center costs, voice systems, and leasehold and office improvements. These assets were written-down to zero. All such assets have been taken out of service.

Activity in the restructuring accrual is as follows:

	Employee Termination Benefits	Occupancy	Contract Cancellations	Total
Restructuring charge	$782,000	$488,000	$529,000	$1,799,000
Cash payments	(343,000)	(47,000)	(365,000)	(755,000)
Reversal of prior accrual	(71,000)	—	(91,000)	(162,000)
Balance at December 31, 1999	$368,000	$441,000	$ 73,000	$ 882,000
Cash payments	(339,000)	(155,000)	(73,000)	(567,000)
Accrual adjustment	—	12,000	—	12,000
Balance at December 31, 2000	$ 29,000	$298,000	$ —	$ 327,000
Cash payments	(10,000)	(91,000)	—	$ (101,000)
Balance at December 31, 2001	$ 19,000	$207,000	$ —	$226,000

Based on revised estimates, $162,000 of the restructuring accrual was reversed by a reduction to the restructuring charge in other underwriting expenses in the fourth quarter of 1999. Employee termination benefits and contract cancellation costs were lower than original estimates.

19—Guaranty Fund and Other Insurance-Related Assessments

The Company accrues for guaranty-fund and other insurance-related assessments in accordance with Statement of Position (SOP) 97-3, “Accounting by Insurance and Other Enterprises for Insurance-Related Assessments.” SOP 97-3 provides guidance for determining when an entity should recognize a liability for guaranty-fund and other insurance-related assessments, how to measure that liability, and when an asset may be recognized for the recovery of such assessments through premium tax offsets or policy surcharges. The Company’s liabilities for guaranty-fund and other insurance-related assessments were $3,605,090 and $880,154 at December 31, 2001 and 2000, respectively. These liabilities included $676,149 and $397,832 related to surcharges collected by the Company on behalf of regulatory authorities for 2001 and 2000, respectively.

20—Interim Financial Data (unaudited)

	2001			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$40,040,902	$41,651,990	$42,598,703	$43,478,259
Total revenues	44,792,026	46,496,969	46,365,986	47,508,642
Net losses and loss expenses	26,158,684	27,931,189	30,026,448	34,061,228
Net income (loss)	2,954,595	2,697,269	1,023,422	(857,155)
Net income (loss) per common share				
Basic	.33	.30	.11	(.10)
Diluted	.33	.30	.11	(.10)

	2000			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	$36,088,698	$36,447,134	$39,149,006	$39,961,361
Total revenues	40,357,333	41,333,363	44,229,060	44,661,831
Net losses and loss expenses	25,948,912	24,823,941	26,795,640	26,814,683
Net income	1,162,682	2,502,499	2,566,975	2,604,624
Net income per common share				
Basic	$.14	$.29	$.29	$.29
Diluted	.14	.29	.29	.29

Independent Auditors' Report

The Stockholders and Board of Directors
Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2001 and 2000, 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, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Donegal Group Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Philadelphia, Pennsylvania
February 21, 2002

Corporate Information

ANNUAL MEETING

April 18, 2002 at the Company's headquarters at 10:00 a.m.

FORM 10-K

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

MARKET INFORMATION

Donegal Group's Class A common stock and Class B common stock are traded on the Nasdaq National Market under the symbols "DGICA" and "DGICB." The Class A common stock and Class B common stock have traded on the Nasdaq National Market since April 20, 2001. All information given prior to that date relates to the Company's Common Stock, which previously traded on the Nasdaq National Market under the symbol "DGIC." The following table shows the dividends paid per share and the stock price range for each quarter during 2001 and 2000:

Quarter	High	Low	Cash Dividend Declared Per Share
2000			
1st	8.625	5.750	—
2nd	8.250	5.750	.09
3rd	8.000	5.750	.09
4th	13.938	7.125	.18
2001 - Class A			
1st	12.750	8.688	—
2nd	14.500	10.000	.10
3rd	14.590	12.170	.10
4th	13.880	9.100	.20
2001 - Class B			
1st	12.750	8.688	—
2nd	12.500	8.750	.09
3rd	13.100	11.010	.09
4th	11.750	9.000	.18

CORPORATE OFFICES

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P.O. Box 302
Marietta, Pennsylvania 17547-0302
(717) 426-1931
E-mail Address: info@donegalgroup.com
Donegal Web Site: www.donegalgroup.com

TRANSFER AGENT

EquiServe Trust Company, N.A.
P.O. Box 2500
Jersey City, New Jersey 07303-2500
(800) 317-4445
Web Site: www.equiserve.com
Hearing Impaired: TDD: 201-222-4955

DIVIDEND REINVESTMENT PLAN

The Company offers a dividend reinvestment plan through its transfer agent.
For information contact:
Donegal Group Inc. Dividend Reinvestment Plan
EquiServe Trust Company, N.A.
P.O. Box 2500
Jersey City, New Jersey 07303-2500

STOCKHOLDERS

The following represent the number of common stockholders of record as of December 31, 2001:

Class A common stock	586
Class B common stock	532

Board of Directors and Officers

DONEGAL GROUP INC.

Board of Directors

Donald H. Nikolaus	*President, Chief Executive Officer and a Director*
Philip H. Glatfelter, II	*Chairman of the Board and a Director*
Robert S. Bolinger	*Director*
Thomas J. Finley, Jr.	*Director*
Patricia A. Gilmartin	*Director*
C. Edwin Ireland	*Director*
John J. Lyons	*Director*
R. Richard Sherbahn	*Director*

Officers

Donald H. Nikolaus	*President and Chief Executive Officer*
Philip H. Glatfelter, II	*Chairman of the Board*
Ralph G. Spontak	*Senior Vice President, Chief Financial Officer, and Secretary*
Daniel J. Wagner	*Vice President and Treasurer*
Jeffrey D. Miller	*Vice President and Controller*

DONEGAL MUTUAL INSURANCE COMPANY

Board of Directors

Donald H. Nikolaus	*President, Chief Executive Officer and a Director*
Philip H. Glatfelter, II	*Chairman of the Board and a Director*
Frederick W. Dreher, III	*Director*
Patricia A. Gilmartin	*Director*
John E. Hiestand	*Director*
C. Edwin Ireland	*Director*
R. Richard Sherbahn	*Director*
William H. Shupert	*Senior Vice President of Underwriting and a Director*
Ralph G. Spontak	*Senior Vice President, Chief Financial Officer, Secretary and a Director*

Other Officers

Kevin G. Burke	*Vice President of Human Resources*
David L. Douglass	*Vice President of Commercial Underwriting*
Kenneth L. Dull	*Vice President of Research and Development*
Charles M. Ferraro	*Vice President of Information Services*
Cyril J. Greenya	*Senior Vice President of Underwriting*
Jeffrey A. Jacobsen	*Vice President of Personal Lines Underwriting*
Perry S. Keith	*Vice President of Internal Audit*
Steven P. Klipa	*Vice President of Casualty Claims*
David S. Krenkel	*Vice President of Marketing*
Jeffrey D. Miller	*Vice President and Controller*
David W. Plouse	*Vice President of Investments*
Robert G. Shenk	*Senior Vice President of Claims*
Daniel J. Wagner	*Vice President and Treasurer*
Janet L. Weisberg	*Vice President of Bodily Injury Claims*

DONEGAL GROUP

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