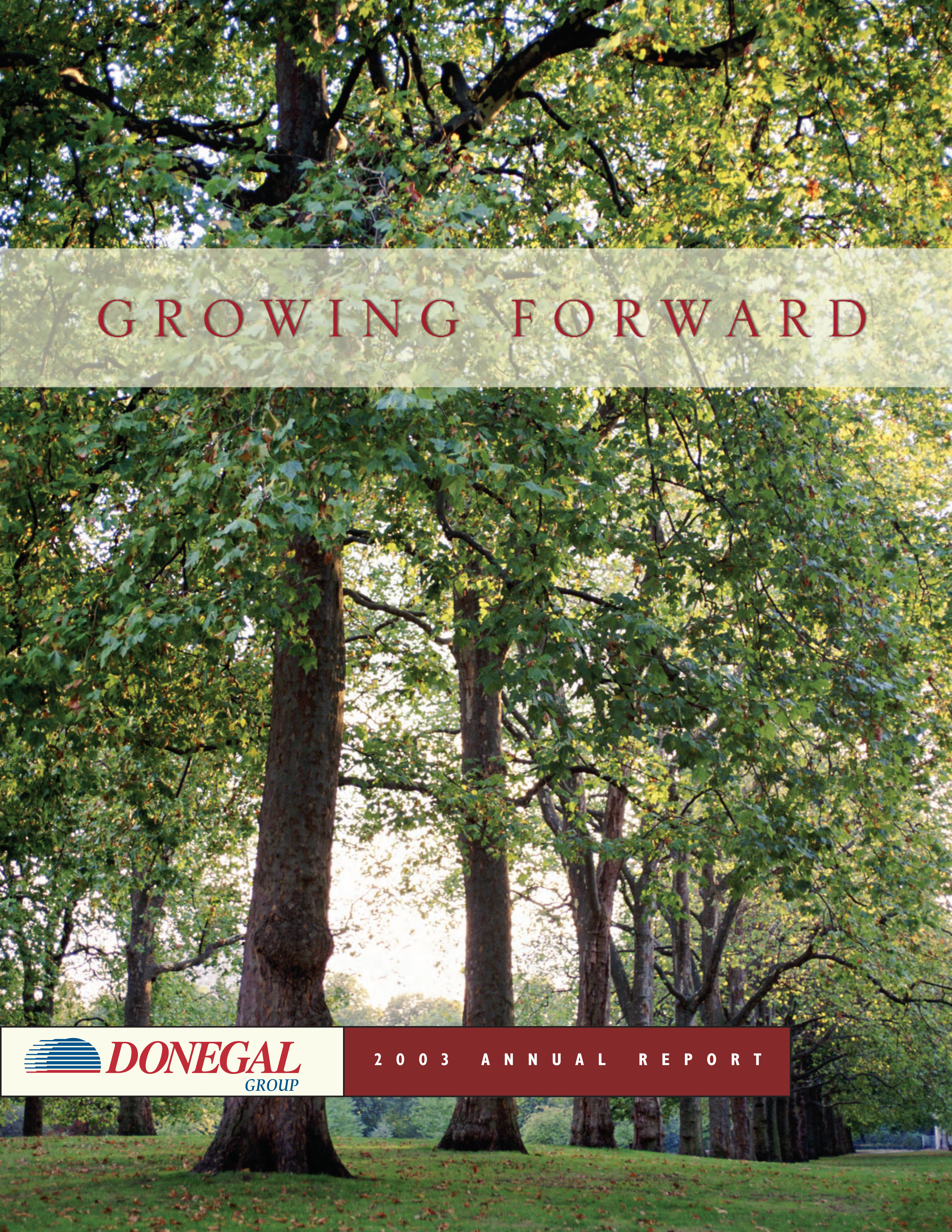
GROWING FORWARD



DONEGAL GROUP

2003 ANNUAL REPORT

Donegal Group Inc. is an insurance holding company offering property and casualty insurance in the Mid-Atlantic, Southeast and Midwest states through our five wholly owned subsidiaries, and through a pooling agreement with our affiliate, Donegal Mutual Insurance Company.

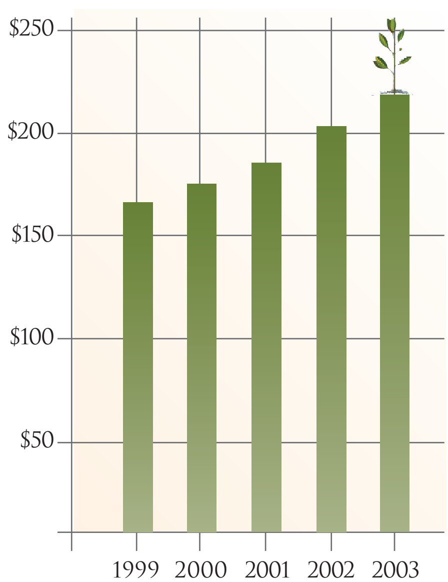
For 2003, our wholly owned subsidiaries included Atlantic States Insurance Company and Southern Insurance Company of Virginia. In January 2004, we acquired Le Mars Insurance Company, Peninsula Indemnity Company and The Peninsula Insurance Company.

We offer full lines of personal and commercial products – including businessowners, commercial multi-peril, automobile, homeowners, boatowners, farmowners, workers' compensation and other coverages. The Donegal Group conducts business through a network of independent insurance agencies.

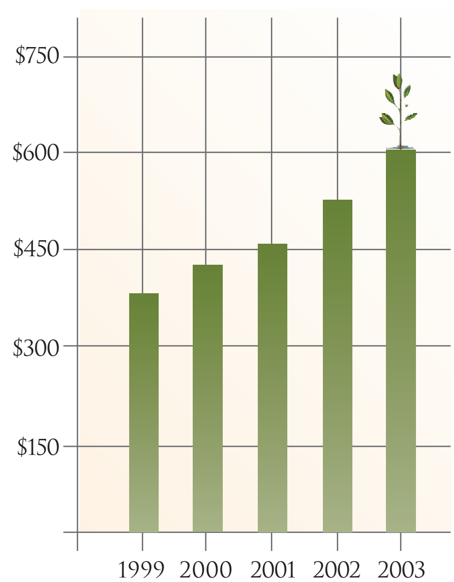
FINANCIAL HIGHLIGHTS

Year Ended December 31,	*2003*	*2002*	*2001*	*2000*	*1999*
Income Statement Data					
Net premiums earned	$196,792,696	$185,841,193	$167,769,854	$151,646,199	$145,517,457
Investment income	13,315,936	14,581,252	15,885,544	16,394,747	13,590,695
Total revenues	214,992,328	203,803,561	185,163,623	170,581,587	161,739,336
Net income	18,293,976	12,002,722	5,818,131	8,836,780	6,795,197
Net income per common share					
Basic	1.91	1.32	0.65	1.01	0.82
Diluted	1.85	1.31	0.64	1.01	0.82
Balance Sheet Data					
Total assets	$602,036,042	$501,218,164	$456,632,372	$426,008,780	$389,688,804
Stockholders' equity	208,649,232	133,182,850	120,928,349	114,129,591	103,792,334
Book value per share	16.29	14.52	13.44	12.88	12.28

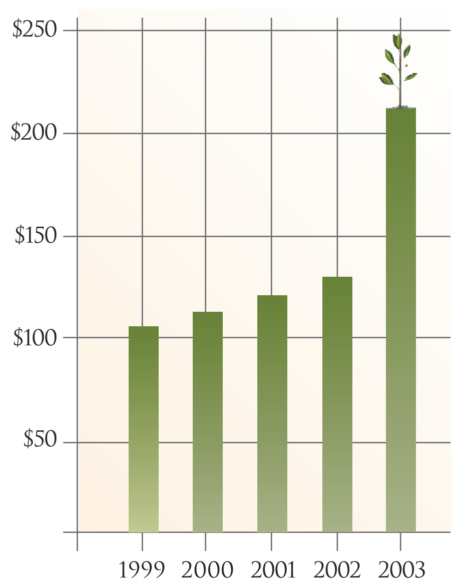
Total Revenues
(in millions)



Total Assets
(in millions)



Stockholders' Equity
(in millions)



TO OUR SHAREHOLDERS & FRIENDS

We are pleased to report that 2003 represented a second straight year of record earnings for the Donegal Group, with 2003 earnings representing a 52.4 percent increase from the prior record year. We attribute our strong earnings performance to the culmination of our longstanding adherence to a conservative underwriting philosophy and our disciplined approach to the attainment of profitable growth.

Our industry as a whole experienced marked improvement in a number of key metrics in 2003, and we believe there are a number of underpinnings that suggest a continuation of the current operating environment, especially in the geographic areas we serve and in the product lines we write. For instance, in many ways our industry is still in recovery mode. Rating agency downgrades continued to outnumber upgrades by a wide margin during the year, indicating that many carriers continue to suffer the effects of underpricing during the soft market. A number of large national carriers have taken corrective actions, including earnings charges related to adverse loss reserve development and other legacy issues. Faced with an eroding capital base and limited opportunities to increase investment income, carriers must maintain and increase premium rates in order to maintain ratings and improve profit levels. Donegal Group is well positioned to capitalize on the opportunities such an environment presents. Because of the nature of the classes of business we have traditionally written, we have avoided many of the issues that have plagued other insurance carriers. We are instead keenly focused on the employment of the disciplined management approach that has led to our growth and financial success.

Our total revenues for 2003 were $214,992,328, a 5.5 percent increase over our revenues of $203,803,561 for 2002. Net income increased significantly to $18,293,976, or $1.85 per share on a diluted basis, in 2003, compared to $12,002,722, or $1.31 per share on a diluted basis, in 2002. We enjoyed improved profitability primarily as a result of reduction in our loss ratio from 69.6 percent in 2002 to 64.2 percent in 2003, despite the impact of a major weather event, as Hurricane Isabel swept through our operating regions in September.

Our excellent 2003 GAAP combined ratio of 95.0 percent compares to the 99.6 percent we posted in 2002, and once again significantly outpaces the projected statutory insurance industry average combined ratio of 101 percent for the year. The combined ratio is the key measure of profitability from insurance underwriting and is a principal indicator of the quality and rate adequacy of the book of business and the expense efficiency in the operations of an individual insurance company. It remains our ongoing goal to attain underwriting profitability – reflected in a combined ratio of less than 100 percent – and we aim to significantly outperform the industry as a whole in this important financial measure.

Our stockholders' equity increased during the year to $208,649,232 at year-end, an increase of 56.7 percent over year-end 2002. Book value per share increased to $16.29 per share at year-end, an increase of 12.2 percent over the book value at December 31, 2002. We completed a very successful follow-on stock offering in late 2003, culminating with the issuance of an additional 3,450,000 shares of Class A common stock. We are pleased to welcome new shareholders, as we employ this additional capital within our corporate business strategy to propel our organization forward.

We recognize that our success is closely tied to the dedicated efforts of our independent agents and our employees. Insurance is an intellectual business, and our people represent our most valuable assets. We express appreciation to the individuals that have contributed to our past success, and we welcome the addition of Le Mars Insurance Company and Peninsula Insurance Group as new subsidiaries of Donegal Group. These acquisitions were effective in early January 2004, and we will endeavor to integrate these companies into the Donegal family. You will read more later in this report about the opportunities and strategic value these companies bring to us.

We continue to appreciate the confidence of our shareholders, and pledge to build upon your trust as we expand our market presence and continue to pursue profitable growth. Donegal Group is "growing forward," and we look forward to what our future holds with much anticipation.

Donald H. Nikolaus, President
Philip H. Glatfelter, II, Chairman of the Board

Donald H. Nikolaus
President

Donegal Group is growing forward. Steady premium growth, an expanding distribution system, increases in capital, new acquisitions, record profitability levels – all key ingredients of our forward progress in 2003. What has generated this forward progress? What do we believe will produce continued positive momentum for Donegal Group in the future?

Discipline and determination. Discipline to stay the course and wait for the right opportunities. Determination to move forward and capitalize when those opportunities arise.

We continue to follow a disciplined and determined approach to the business of writing insurance profitably, and we continue to follow a disciplined and determined approach to pursuing growth, whether organically or by acquisition. Our steadfast commitment to this approach has yielded solid results. We hold fast to the proven management principles that have served us well in the past, and we resolve to build on our sound heritage of financial strength and generate shareholder value. We believe Donegal Group will continue to grow forward as we apply discipline and determination in every aspect of our business.

We have long regarded underwriting profitability to be critical to the prosperity of a property and casualty insurance organization. However, it takes a high level of discipline to attain underwriting profitability in an intensely competitive industry where large national carriers often attempt to set the rules of the game. We attribute our record of consistently outperforming the industry in terms of underwriting profitability to our steady attention to the basics of our business and the ongoing development of a conservative underwriting culture.

Discipline to stay the course.
Determination to move forward.

Simply stated, we write what we know, and we know what we write. We do not offer exotic insurance coverages, nor do we write heavy industrial accounts. We choose rather to target preferred classes of business and commercial accounts that do not contain inordinate amounts of risk. We are selective in the quality of personal and commercial accounts we will accept, adhering to strict underwriting standards and avoiding high concentrations of exposure in catastrophe-prone areas. We inspect every commercial account we write to ensure that we understand the nature of the risk and are pricing our policies proportionately to our exposure.

We are also keenly focused on expense control, constantly exploring ways to streamline our operations and eliminate unnecessary costs. We continue to implement state-of-the-art technology to improve on a continuing basis our processing efficiency and to enhance the ease of doing business with our companies for our agents and policyholders. For example, we expect to roll out our Real Time Agent Interface to our agency force in 2004, which we anticipate will greatly streamline the processing of our personal lines policy quotes and submissions. Our personal lines optical imaging implementation several years ago has resulted in substantial efficiency gains, and we are currently expanding this system to include commercial policy documents. The imaging of commercial policy information is expected to further improve processing workflows and will provide multiple users instantaneous access to policies, policy applications and related documentation.

Our disciplined approach to the attainment of underwriting profitability is most readily apparent in the daily "blocking and tackling" consistently performed by dedicated professionals who understand our game plan and are motivated to attain the desired results.

We believe that our regional approach to serving our insurance customers has numerous advantages, and we are continuing to build upon that approach as we strive to profitably grow our organization. The primary advantage of our regional business model is our ability to provide specialized agency and customer service at the regional level. Marketing, underwriting and claims personnel in a regional office are able to garner extensive local market knowledge and expertise, making them ideally suited to perform their key functions within the region where they live and work. On the other hand, we centralize certain back office functions from the regions to our administrative headquarters, thereby gaining economies of scale and achieving operating efficiencies that benefit our entire operation as well as our bottom line.

We are now directing our marketing efforts to three distinct geographic regions, which we refer to as Mid-Atlantic, Southeast and Midwest. We are expanding our distribution system by appointing quality

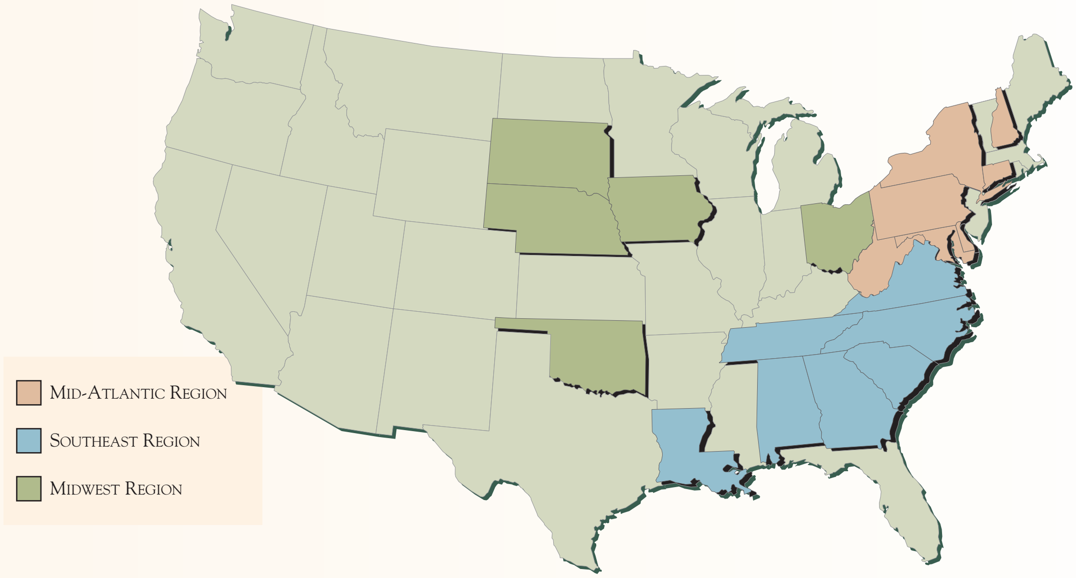
Steady attention to the basics and a conservative underwriting culture.

independent agencies in these regions, employing a disciplined screening process to make sure potential agency partners' operating philosophies and growth goals are consistent with our own.

Mid-Atlantic Region. This region consists of the states of Pennsylvania, Maryland, Delaware and New York. Our largest concentration of business is located in this stable and profitable region, and we believe additional market penetration can be obtained as we further solidify existing agency relationships and seek quality agencies to add to our regional distribution system. Our January 2004 acquisition of the Peninsula Insurance Group bolsters our agency representation within this region and provides additional critical mass by adding similar and complimentary products to our traditional product mix in Peninsula's primary operating states of Maryland, Virginia and Delaware.

Southeast Region. We entered the Southeast Region through the acquisition of two companies based in Virginia and Georgia, respectively. These companies were merged in 2001, and Southern Insurance Company of Virginia is now actively building on its core book of business in seven Southeastern states. The demographics within this region are quite strong compared to many other regions of the country, as the population and small businesses continue to grow and expand. This environment is particularly favorable for quality premium growth in the lines and types of business we write, and we are concentrating our efforts to increase our market presence in this high-growth region. Our introduction of commercial products in the Southeast has begun to provide a significant stream of additional revenue, and we expect additional personal and commercial premium growth from this region in the future.

Midwest Region. Through the continuing development of our operations in the state of Ohio, we have acquired a foothold in the Midwest area of the country. We are experiencing increasing levels of growth in



Ohio as we continue to actively appoint new agencies and pursue quality premium growth. Our plan was to leverage the market knowledge generated within our Ohio operation to develop a third marketing region in the Midwest states. This strategy led to the acquisition of Le Mars Insurance Company in January 2004, which has provided an entrance into four additional states at the western edge of our developing Midwest region. Le

Our regional business model enables us to provide specialized agency and customer service.

Mars writes similar lines of business to our other subsidiaries and operates in the states of Iowa, Nebraska, Oklahoma and South Dakota. We plan to further expand our presence in this region over time by targeting acquisitions and affiliations in the states between Ohio and the Le Mars operating states.

Acquisitions have played a considerable role in the construction of our successful growth record over the past decade. As of January 2004, we have completed seven acquisitions of small to medium-sized insurance companies, a number of which have been merged into other subsidiaries in recent years to streamline our corporate structure. We continue to pursue additional acquisitions that fit within our preferred target profile and geographic expansion objectives.

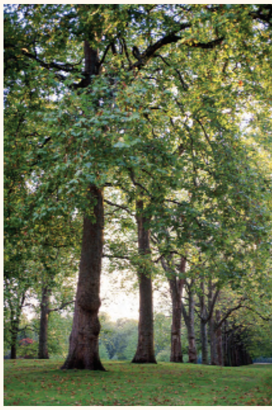
We follow a very disciplined approach when considering an acquisition target. Through extensive due diligence procedures, we endeavor to gain a thorough understanding of the present and potential issues impacting the target company. We only consider targets that write similar lines of business to those we currently write, so that we do not assume undue risk by entering into lines of business in which we have limited expertise. We limit our consideration of potential acquisition candidates to companies of a size that represent an adequate growth opportunity, but without being so large as to make integration into our organization an overly difficult task.

We believe that we have an unusually diverse array of methods we can utilize to grow by acquisition. We can purchase a company outright for cash or stock, we can purchase a book of business or enter into reinsurance transactions should the right opportunity arise, and we can participate in "mutual to mutual" transactions in conjunction with our affiliate, Donegal Mutual Insurance Company.

Donegal Mutual made a surplus note investment in Le Mars Mutual in 2002. The process to convert Le Mars from a mutual to a stock company began in 2003, and policyholders and regulatory officials approved the transaction late in the year. As of January 1, 2004, Donegal Group acquired the stock of Le Mars through surplus payments to the Le Mars policyholders and payment of the surplus note and accrued interest to Donegal Mutual. As a result, Le Mars became a wholly owned stock subsidiary of Donegal Group. Le Mars is a strategic acquisition by virtue of its location in the Midwest region we have targeted for expansion, and we believe Le Mars is in position to provide an additional revenue stream and source of growth for our operations.

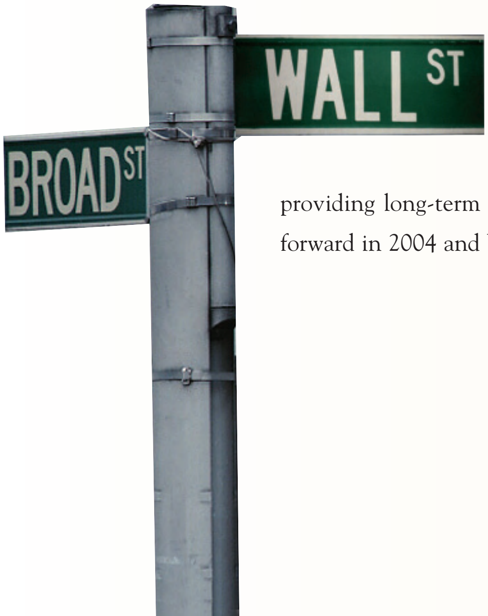
In a separate transaction, we acquired Peninsula Insurance Group for cash on January 6, 2004, purchasing Peninsula from a large insurance organization. Peninsula has a solid book of business in states in which we

Growth through disciplined acquisition strategy.



currently operate and has historically been well managed and profitable. There is limited crossover within our respective agency forces, and we believe our combined resources and management talent will result in many benefits to both operations.

Operating from a position of financial strength is nothing new for Donegal Group. Our investment philosophy, carefully managed leverage ratios and prudent debt levels have served us well as our business has grown. Recognizing the advantages to supporting current and future growth through additional capital, Donegal Group issued an additional 3,450,000 shares of our Class A common stock in a follow-on offering in late 2003. Our disciplined strategy and growth and earnings record were well received by the investment community as we clearly outlined our plan to utilize a significant portion of the offering proceeds in the then-pending Le Mars and Peninsula acquisitions and in surplus contributions to our other insurance subsidiaries to support their organic growth. We also participated in two offerings of trust preferred securities during 2003, the proceeds of which further increase our ability to fund future growth. As we enter 2004, Donegal Group is in a strong position to put this additional capital to work. We are focused, energized and operating from a position of strength. We remain deeply committed to providing long-term shareholder value as we continue to apply discipline and determination to grow forward in 2004 and beyond.



Selected Consolidated Financial Data

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

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

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

Financial Information

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

General

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

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

Transactions with Affiliates

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

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

- catastrophe reinsurance agreements with each of our insurance subsidiaries,
- an excess of loss reinsurance agreement with Southern
- a workers' compensation reallocation agreement with Southern and
- a 100% retrocessional agreement with Southern.

The excess of loss and catastrophe reinsurance agreements are intended to lessen the effects of a single large loss, or an accumulation of losses arising from one event, to levels that are appropriate given each subsidiary's size, underwriting profile and surplus position. The Mutual Company and Southern have an agreement in place to reallocate the loss results of workers' compensation business written by Southern as part of commercial accounts primarily written by the Mutual Company or Atlantic States. This agreement provides for the workers' compensation loss ratio of Southern to be no worse than the average workers' compensation loss ratio for the Donegal Insurance Group.

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

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

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

Critical Accounting Policies and Estimates

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

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

Liability for Losses and Loss Expenses

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

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

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

Investments

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

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

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

Policy Acquisition Costs

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

Guaranty Fund Liability Accruals

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

Management Evaluation of Operating Results

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

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

Results of Operations
Years Ended December 31, 2003 and 2002

Net Premiums Written

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

Net Premiums Earned

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

Investment Income

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

Net Realized Investment Gains/Losses

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

Losses and Loss Expenses

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

Underwriting Expenses

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

Combined Ratio

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

Interest Expense

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

Income Taxes

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

Net Income and Earnings Per Share

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

Book Value Per Share and Return on Equity

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

Years Ended December 31, 2002 and 2001

Net Premiums Written

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

Net Premiums Earned

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

Investment Income

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

Net Realized Investment Gains/Losses

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

Losses and Loss Expenses

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

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

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

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

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

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

Financial Condition

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

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

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

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

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

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

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

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

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

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

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

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

Investments

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

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

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

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

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

Quantitative and Qualitative Disclosures About Market Risk

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

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

Interest Rate Risk

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

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

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

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

Equity Price Risk

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

Credit Risk

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

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

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

Impact of Inflation

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

Donegal Group Inc.

Consolidated Balance Sheets

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

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Income and Comprehensive Income

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

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Stockholders' Equity

	Common Stock						Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Stockholders' Equity
	Prior Shares	Class A Shares	Class B Shares	Prior Amount	Class A Amount	Class B Amount					
Balance, January 1, 2001	8,980,977	—	—	$8,980,977	$ —	$ —	$ 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
Issuance of common stock		166,972			1,670		1,641,547				1,643,217
Net income									12,002,722		12,002,722
Cash dividends									(3,526,157)		(3,526,157)
Exercise of stock options		4,907	2,777		49	27	84,455				84,531
Grant of stock options							38,034		(38,034)		—
Other comprehensive income								2,050,188			2,050,188
Balance, December 31, 2002	—	6,269,093	3,024,742	$ —	$62,691	$30,247	$ 60,651,751	$ 4,911,953	$68,417,956	$(891,748)	$133,182,850
Issuance of common stock		3,547,000			35,470		60,193,670				60,229,140
Net income									18,293,976		18,293,976
Cash dividends									(4,360,026)		(4,360,026)
Exercise of stock options		64,413	27,069		644	271	923,407				924,322
Grant of stock options							976,077		(976,077)		—
Other comprehensive income								378,970			378,970
Balance, December 31, 2003	—	9,880,506	3,051,811	$ —	$98,805	$30,518	$122,744,905	$ 5,290,923	$81,375,829	$(891,748)	$208,649,232

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Cash Flows

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

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1—Summary of Significant Accounting Policies

Organization and Business

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

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

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

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

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

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

Basis of Consolidation

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

Use of Estimates

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

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

Investments

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

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

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

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

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

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

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

Fair Values of Financial Instruments

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

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

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

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

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

Revenue Recognition

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

Policy Acquisition Costs

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

Property and Equipment

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

Losses and Loss Expenses

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

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

We have no material exposures to environmental liabilities.

Guaranty Fund Liability Accruals

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

Income Taxes

We currently file a consolidated federal income tax return.

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

Credit Risk

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

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

Reinsurance Accounting and Reporting

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

Stock-Based Compensation

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

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

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

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

Earnings per Share

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

2— Transactions with Affiliates

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

a. Reinsurance Pooling and Other Reinsurance Arrangements

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

Prior to January 1, 2002, the Mutual Company and Southern had a quota share agreement whereby Southern ceded 50% of its direct business, less reinsurance, to the Mutual Company. The business assumed by the Mutual Company from Southern became part of the pooling arrangement between the Mutual Company and Atlantic States. Southern ceded premiums earned of $0, $0 and $14,995,606 and ceded losses and loss expenses incurred of $(73,077), $488,055 and $9,898,422 under this agreement during 2003, 2002 and 2001, respectively. Southern had prepaid reinsurance premiums of $0, $0 and $7,310,471 and a ceded liability for losses and loss expenses of $4,175,127, $6,399,727 and $10,068,604 under this agreement at December 31, 2003, 2002 and 2001, respectively. This agreement was terminated as of January 1, 2002.

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

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

b. Expense Sharing

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

c. Lease Agreement

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

d. Legal Services

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

e. Province Bank

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

3—Investments

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

2003				
Held to Maturity	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 29,130,684	$ 66,050	$368,967	$28,827,767
Canadian government obligation	499,630	25,370	—	525,000
Obligations of states and political subdivisions	45,187,284	1,117,513	60,847	46,243,950
Corporate securities	25,192,044	2,086,465	9	27,278,500
Mortgage-backed securities	13,041,142	287,732	71,089	13,257,785
Totals	$113,050,784	$3,583,130	$ 500,912	$116,133,002

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We have no derivative instruments or hedging activities.

4—Deferred Policy Acquisition Costs

Changes in deferred policy acquisition costs are as follows:

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

5—Property and Equipment

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

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

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

6—Liability for Losses and Loss Expenses

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

	2003	2002	2001
Balance at January 1	$210,691,752	$179,839,905	$156,476,124
Less reinsurance recoverable	79,583,319	65,295,790	53,766,710
Net balance at January 1	131,108,433	114,544,115	102,709,414
Incurred related to:			
Current year	126,693,421	122,433,653	110,142,467
Prior years	(450,110)	6,834,033	8,035,082
Total incurred	126,243,311	129,267,686	118,177,549
Paid related to:			
Current year	72,187,103	67,655,902	63,289,736
Prior years	46,268,571	45,047,466	43,053,112
Total paid	118,455,674	112,703,368	106,342,848
Net balance at December 31	138,896,070	131,108,433	114,544,115
Plus reinsurance recoverable	79,017,987	79,583,319	65,295,790
Balance at December 31	$217,914,057	$210,691,752	$179,839,905

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

7—Borrowings

Line of Credit

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

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

Subordinated Debentures

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

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

8—Reinsurers

Unaffiliated Reinsurers

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

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

Total Reinsurance

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

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

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

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

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

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

9—Income Taxes

The provision for income tax consists of the following:

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

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

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

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

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

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

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

10—Stockholders' Equity

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

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

11—Stock Compensation Plans

Equity Incentive Plans

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

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

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

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

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2000	1,516,338	$13.19
Granted – 2001	459,000	13.93
Exercised – 2001	13,315	8.00
Forfeited – 2001	27,556	13.50
Outstanding at December 31, 2001	1,934,467	$13.27
Granted – 2002	10,000	14.00
Exercised – 2002	7,684	8.00
Forfeited – 2002	18,334	14.36
Expired – 2002	524,448	13.50
Outstanding at December 31, 2002	1,394,001	$13.43
Granted – 2003	667,500	12.00
Exercised – 2003	91,482	8.15
Forfeited – 2003	14,000	10.57
Expired – 2003	476,667	18.00
Outstanding at December 31, 2003	1,479,352	$11.72
Exercisable at:		
December 31, 2001	1,321,905	$13.89
December 31, 2002	1,085,000	$13.29
December 31, 2003	883,707	$11.11

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

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

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

Employee Stock Purchase Plans

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

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

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

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

Agency Stock Purchase Plans

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

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

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

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

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

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

13—Reconciliation of Statutory Filings to Amounts Reported Herein

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

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

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

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

14—Supplementary Cash Flow Information

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

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

15—Earnings Per Share

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

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

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

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

16—Condensed Financial Information of Parent Company

Condensed Balance Sheets

($ in thousands)

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

Condensed Statements of Income and Comprehensive Income

($ in thousands)

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

Condensed Statements of Cash Flows

($ in thousands)

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

17—Segment Information

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

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

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

Financial data by segment is as follows:

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

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

18—Guaranty Fund and Other Insurance-Related Assessments

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

19—Interim Financial Data (unaudited)

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

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

Independent Auditors' Report

The Stockholders and Board of Directors
Donegal Group Inc.

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Donegal Group Inc. and subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Philadelphia, Pennsylvania
February 19, 2004

CORPORATE INFORMATION

Annual Meeting

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

Form 10-K

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

Market Information

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

Quarter	High	Low	Cash Dividend Declared Per Share
2002 - Class A			
1st	$10.770	$8.750	$—
2nd	12.250	9.050	.10
3rd	10.990	9.120	.10
4th	12.120	9.250	.20
2002 - Class B			
1st	12.800	8.780	—
2nd	11.000	9.750	.09
3rd	11.500	9.510	.09
4th	11.440	9.200	.18
2003 - Class A			
1st	11.750	9.500	—
2nd	15.200	10.980	.10
3rd	19.000	12.100	.11
4th	23.970	15.250	.22
2003 - Class B			
1st	11.320	10.720	—
2nd	13.790	10.350	.09
3rd	16.010	11.760	.10
4th	20.000	14.750	.20

Corporate Offices

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

Transfer Agent

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

Dividend Reinvestment and Stock Purchase Plan

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

Stockholders

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

Class A common stock	638
Class B common stock	479

BOARD OF DIRECTORS & 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*
Patricia A. Gilmartin	*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*

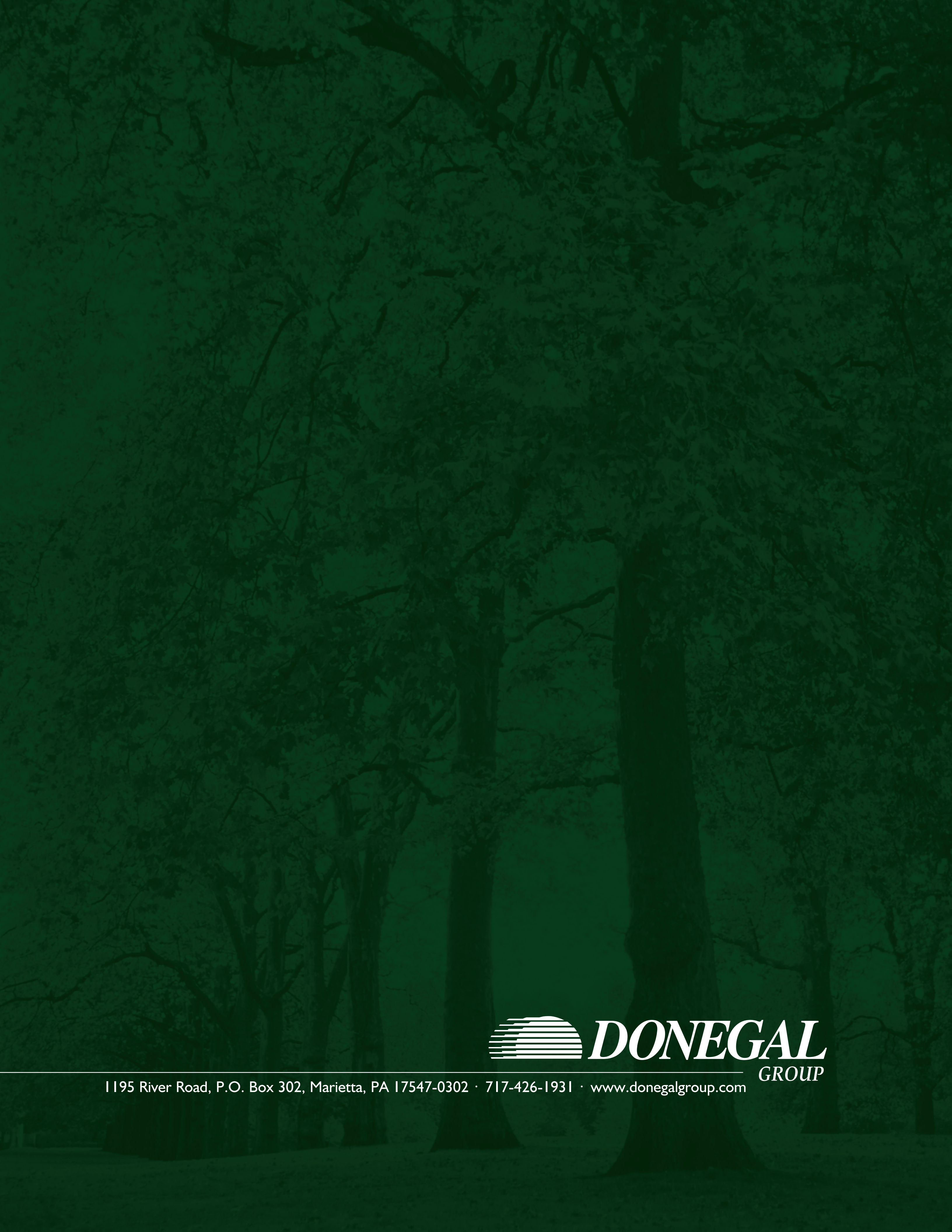
DONEGAL MUTUAL INSURANCE COMPANY

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*
Kevin M. Kraft, Sr.	*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*
Kenneth L. Dull	*Vice President of Research and Development*
Charles M. Ferraro	*Vice President of Information Services and Chief Information Officer*
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*
Richard G. Kelley	*Vice President of Commercial Underwriting*
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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