

An ongoing commitment to growth and profitability.

20 years



2006 ANNUAL REPORT

Donegal Group 
founded 1986

1889

about the cover:

The year 2006 marks
20 years since Donegal
Mutual Insurance Company
formed Donegal Group and we
completed our initial public
stock offering in 1986.

Our annual reports have
chronicled Donegal Group's
consistent progress over the
past 20 years, and we
continue to enjoy the benefits
of a heritage that dates back
more than a century to the
founding of Donegal Mutual
Insurance Company in 1889.

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

Our wholly owned subsidiaries include Atlantic States
Insurance Company, Le Mars Insurance Company, Peninsula
Indemnity Company, The Peninsula Insurance Company
and Southern Insurance Company of Virginia.

Offering full lines of personal, farm and commercial products
including businessowners, commercial multiperil, automobile,
homeowners, boatowners, farmowners, workers' compensation
and other coverages, our subsidiaries and Donegal Mutual
Insurance Company conduct business through a network
of independent insurance agencies.



"WE ARE COMMITTED TO A CONTINUATION OF THE SOUND BASIC PRINCIPLES THAT HAVE GUIDED OUR
COMPANIES FOR 98 YEARS, COUPLED WITH OUR FOCUS ON GROWTH AND PROGRESS GOING FORWARD."

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Financial Highlights

2006 ANNUAL REPORT

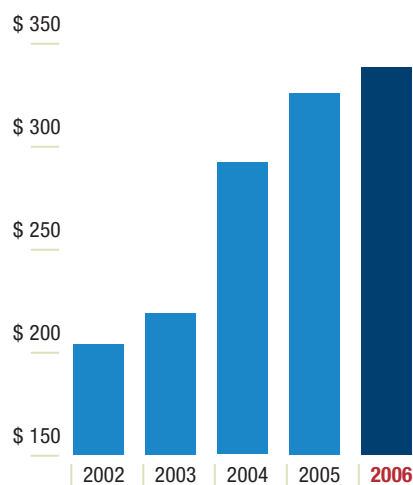
Year Ended December 31,	2002	2003	2004	2005	2006
Income Statement Data					
Net premiums earned	\$185,841,193	\$196,792,696	\$265,838,594	\$294,498,023	\$301,478,162
Investment income	14,581,252	13,315,936	15,906,728	18,471,963	21,320,081
Total revenues	203,803,561	214,992,328	287,788,638	319,847,194	329,967,034
Net income	12,002,722	18,293,976	31,614,269	36,949,497	40,214,722
Net income per common share					
Basic earnings per common share	.74*	1.07*	1.35*	1.54*	1.61
Diluted earnings per common share	.74*	1.04*	1.31*	1.49*	1.57

Balance Sheet Data

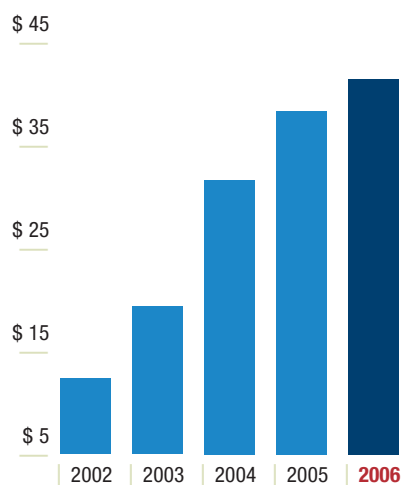
Total assets	\$501,218,164	\$602,036,042	\$735,415,401	\$781,421,588	\$831,697,811
Stockholders' equity	133,182,850	208,649,232	242,704,314	277,896,186	320,802,262
Book value per share	8.17*	9.17*	10.15*	11.30*	12.70

*Restated to reflect a 4-for-3 stock split effected in the form of a 33⅓% stock dividend on April 26, 2006

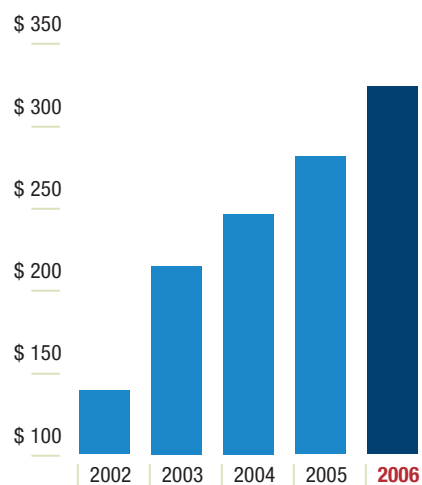
Total Revenues [in millions]



Net Income [in millions]



Stockholders' Equity [in millions]



86

DGI is organized by
Donegal Mutual

DGI completes
initial public offering

Total revenues of
\$30.6 million achieved in
first full year of operations;
stockholders' equity
nears \$19 million

Southern Insurance
Company of Virginia acquired
after converting from mutual
to stock company

1986

1987

1988





Donald H. Nikolaus
President

Philip H. Glatfelter II
Chairman of the Board

To Our Stockholders and Friends

We are pleased to report to you that Donegal Group achieved record earnings again in 2006, an accomplishment we have now reported for five consecutive years. As we consider the significance of passing the milestone of 20 years since our initial public stock offering in November 1986, we are reminded anew of the goals we set out to achieve at Donegal Group's formation. This annual report chronicles our progress in achieving those goals, and reflects the soundness of the operating strategies we have consistently employed in building our organization. Our commitment to the business principles upon which Donegal Group was founded remains firm, and our results amply prove the validity of those business principles.

Despite ominous predictions by weather experts in the wake of record hurricane and tropical storm activity in 2005, relatively mild weather during 2006 contributed to a profitable year for most property and casualty insurers. Increased profits and enhanced capital levels have produced a competitive insurance marketplace where top-line premium growth is more difficult to achieve. As market competition has intensified, we have maintained our emphasis on underwriting discipline throughout our organization, striving to exercise patience in our committed pursuit of profitable growth. We are certainly striving for top-line growth, but we see little benefit to be gained by compromising rate adequacy or unduly expanding our risk appetite, thereby jeopardizing our bottom-line profitability for the sake of showing an increase in premium writings.

Our total revenues for 2006 were \$329,967,034 representing a 3.2 percent increase over the \$319,847,194 in revenues for 2005. Our net income increased to a record \$40,214,722, or \$1.57 per share on a diluted basis, in 2006, compared to \$36,949,497, or \$1.49 per share on a diluted basis, in 2005. As in past years, record underwriting profitability along with increased investment income accounted for the majority of the increase in our net income.

“THE DONEGAL GROUP HAS GROWN IN SIZE AND FINANCIAL STRENGTH SINCE 1986 AND WE ARE ABLE TO TAKE ADVANTAGE OF THE BUSINESS OPPORTUNITIES PRESENTED BY BOTH BAD AND GOOD ECONOMIC TIMES.”

2

— 1991 ANNUAL REPORT



Donegal Mutual completes new headquarters with new computer center

DGI reports record earnings of just over \$4 million

1989



Extensive renovation of headquarters adding advanced technological capabilities

1990

DGI celebrates five years of growth with total revenues of \$58.5 million

1991

st

We measure our underwriting profitability by our combined ratio, a metric widely considered to be a principal indicator of the levels of underwriting discipline and processing efficiency in the operations of an insurance company. Our 2006 GAAP combined ratio of 89.0 percent eclipsed the historically unprecedented 89.5 percent combined ratio we posted in 2005. We maintained our historic significant outperformance of the property and casualty insurance industry average combined ratio, a goal we have accomplished consistently across the past 20 years. Our loss ratio of 55.8 percent in 2006 compared favorably to the 56.9 percent we reported in 2005, reflecting relatively mild weather conditions and favorable prior year loss reserve development.

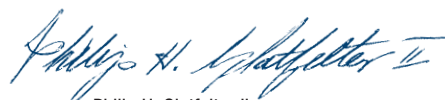
We have steadily increased our dividend rates over the past two decades to provide a return to our stockholders, while at the same time ensuring that we are adequately enhancing our capital base by reinvesting a large percentage of our operating profits. Our stockholders' equity climbed to \$320,802,262 at year-end, increasing 15.4 percent during 2006. Our book value per share reached \$12.70 at year-end, representing a 12.4 percent increase over our book value per share at the end of 2005.

We have welcomed many new independent agents to our organization within the past few years in our continuing efforts to expand our market presence in the various regions we serve. We maintain our strong commitment to the independent agency system, and we recognize that our success is closely tied to the relationships we have built with our agents over the years. We look forward to the prospects for continued success as we cultivate our agency relationships in our mutual quest for quality premium growth.

To those stockholders that have journeyed with us for the past 20 years, we appreciate your commitment in standing with us over the long-term, and we are pleased with the value we have been able to generate for your investment in Donegal Group. To all of our stockholders, rest assured that we will continue our efforts to earn the trust you have placed in us, and we are committed to the effective execution of our time-proven business strategies in 2007 and beyond.



Donald H. Nikolaus
President



Philip H. Glatfelter II
Chairman of the Board

75 new agencies added,
bringing total number to nearly
600 agencies in four states

Donegal named to Ward's 50 list
of superior performing companies

Secondary public stock offering
raises \$16 million of new capital

Completion of major computer
system upgrade

DGI weathers the worst
winter storms experienced
in PA in 100 years



Commitment to Underwriting Profitability

Shortly after the initial public stock offering of Donegal Group in 1986, we made four basic commitments. We committed to maintain underwriting profitability, pursue prudent growth, develop a diversified business mix and improve the efficiency of our operations. Twenty years have passed since we first set out to fulfill those commitments. Much has changed over that period of time, and yet we remain very much committed to the strategic objectives formulated when Donegal Group was founded. We invite you to look back with us as we review our progress in fulfilling these commitments over the past twenty years.

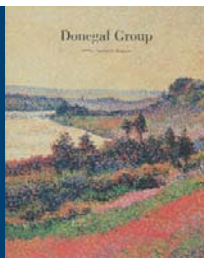
We continue to hold fast to our long-standing goal of outperforming the property and casualty insurance industry in terms of underwriting profitability (as measured by the combined ratio), an objective we have consistently achieved over our twenty-year history. This achievement has not happened by accident, but rather by an intentional focus on underwriting quality. We continue to draw upon our heritage of conservative underwriting as we expand into new markets and enhance our product offerings. After 2001 as the insurance market hardened and rates increased, our commitment to underwriting discipline positioned our companies to benefit from the improved market conditions. As a result, we have enjoyed record levels of underwriting profits in recent years. History has shown that Donegal Group has been able to outperform the industry in good and bad economic or market conditions, and we are prepared to work hard to preserve our rate adequacy and profitability levels in the face of competitive challenges within our markets in the days and years ahead.



“ OVER THE PAST TEN YEARS, WE HAVE ENDEAVORED TO BALANCE OUR CONSERVATIVE OPERATING PHILOSOPHY WITH A STRATEGIC CONCENTRATION ON EXPANDING OUR OPERATIONS AND INCREASING OUR PROFITABILITY.”

4

— 1997 ANNUAL REPORT



Delaware Atlantic Insurance Company acquired after converting from mutual to stock company

Total revenues exceed the \$100 million mark; stockholders' equity exceeds \$80 million

DGI announces 4-for-3 stock split

DGI acquires Pioneer Insurance Company of Ohio from Donegal Mutual

Donegal launches an Internet web site at www.donegalgroup.com

1995

1996

1997

Commitment to Prudent Growth

We reported net premiums earned of \$28.2 million in 1987, our first full year of operations. Through various growth initiatives, both organic and acquisition, we have steadily grown our book of business, reaching premiums earned of \$301.5 million in 2006, translating to a compound annual growth rate of over 13%. We remain strongly committed to the independent agency system as our sole means of product distribution. We have increased our agency representation from approximately 1,200 independent agencies in 1986 to approximately 2,000 today, and we continue to pursue additional quality agencies to represent us in our various marketing regions.

Since our formation, Donegal Group has acquired seven insurance companies and completed a formal book transfer through an acquisition rights agreement with another. In so doing, we have developed experience utilizing a number of acquisition methods, giving us a menu of options to employ as we pursue additional acquisitions. In addition to outright purchases and book transfers, our affiliation with Donegal Mutual affords us the ability to benefit from mutual-to-mutual affiliations that have provided four of our acquisitions to date.

In December 2006, Donegal Mutual announced the signing of an agreement to affiliate with Sheboygan Falls Mutual Insurance Company. Sheboygan Falls Mutual is a modest-sized mutual company transacting business in Wisconsin since the late 1800s. Subject to regulatory approval, Donegal Mutual's affiliation with Sheboygan Falls Mutual would represent a step forward in our expansion into the Midwest region of the country. In addition to financial assistance, Donegal Mutual will provide technology to Sheboygan Falls Mutual to facilitate premium growth and to increase operational efficiency. At some point in the future and subject to regulatory approval, Sheboygan Falls Mutual may pursue a conversion to a stock company, thereby making possible a potential acquisition by Donegal Group in a similar manner to several previous acquisition transactions that have been successfully completed in the past, including the demutualization and acquisition of Le Mars Insurance Company in 2004.

Donegal remains committed to the pursuit of prudent growth, actively endeavoring to appoint new agents, increase market penetration and add to our family of companies.

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20 years

DGI announces 4-for-3 stock split

DGI achieves tenth consecutive year of growth and profitability

Southern Heritage Insurance Company acquired; stockholders' equity tops \$100 million

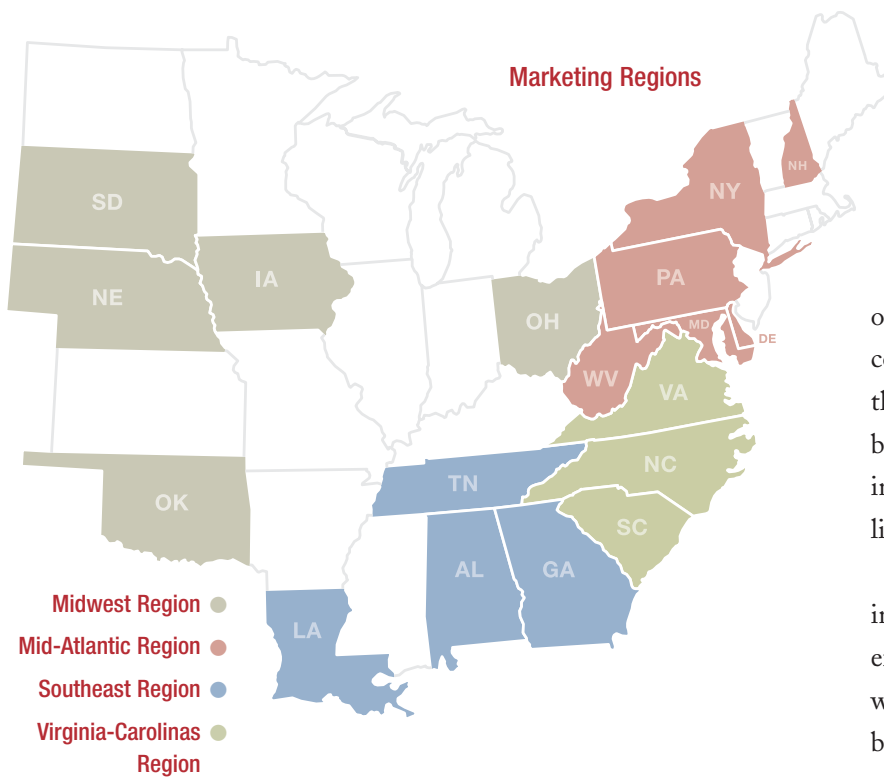
DGI executes a comprehensive restructuring plan



Province Bank formed jointly by Donegal Mutual and DGI

"Y2K" passes without incident





Commitment to Diversify Our Business

Over the years, we have strived for diversification within our business, both by balancing our product lines and expanding into new geographic regions. In the early years, we expanded our commercial lines product offerings and increased our writings of commercial accounts to nearly 50% of our total business. In recent years, our mix has shifted slightly as we acquired several companies that were more heavily concentrated in personal lines, providing

opportunities for us to steadily introduce our commercial products in the markets served by the acquired companies. We currently enjoy a balanced product mix with our premium writings consisting of approximately 60% personal lines and 40% commercial lines business.

Seeking geographical diversity to insulate ourselves against the potential negative effects of localized business conditions and large weather events in a particular region, we have branched out from three Mid-Atlantic states in which we wrote business in 1986 to 18 states throughout the Mid-Atlantic, Southeastern and Midwestern regions of the country today. We continue to seek growth within our independent agency distribution system as we strive to increase brand recognition and obtain organic premium growth in established regions. Through a multifaceted acquisition growth strategy, we have gained access to new markets and expanded our presence in markets where we were already active. Our pursuit for advantageous acquisition candidates continues as we seek to further diversify our book of business.



DGI acquires Pioneer Insurance Company of New York from Donegal Mutual

DGI revises corporate structure to include two classes of common stock

DGI completes streamlining of its corporate structure by merging subsidiaries into Atlantic States Insurance Company and Southern Insurance Company of Virginia

New Technology Center completed

Total revenues exceed \$200 million with stockholders' equity of \$133 million

Follow-on offering provides \$59 million additional capital, boosting stockholders' equity above \$200 million

Commitment to Improve Operational Efficiency

Throughout our twenty-year history, we have implemented many technological advances that have improved the efficiency of our operations and allowed us to compete effectively with the levels of technology employed by much larger competitors. The changes in technology over our twenty-year existence have been staggering – from the introduction of personal computers and laser printers to digital imaging and interactive web-based processing. Within the past two years, we have implemented the latest web-based versions of our WritePro and WriteBiz automated underwriting and policy issuance systems that have put us on a level playing field with industry leaders in terms of technological capabilities. We are promoting the usage of these systems by our agents and are optimistic about our growth potential as these systems continue to gain traction in our various marketing regions.

We will implement a new web-based claims handling system in 2007 to enhance significantly the automation of our claims operations. This state-of-the-art processing system will be fully integrated with our existing document imaging processing system to streamline the claim reporting and handling processes and allow more efficient utilization of our resources.

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20 years

We look forward to the benefits this new system will provide, anticipating that it will significantly enhance our ability to fulfill our longstanding commitment to deliver superior claims service.

Looking Forward

We can only speculate as to what the future holds, and an analysis of predictions from twenty years past would indicate that it is somewhat futile to do so. One thing is certain – change is inevitable. Yet, despite all that has changed over the years, some things remain constant. The core values upon which Donegal Group was founded have stood the test of time. As we look forward to the opportunities the future holds, we renew our commitment to the business principles we know to be beneficial to our long-term growth and stability, seeking to continue our twenty-year history of providing long-term stockholder value.

“OVER THE YEARS, WE HAVE BUILT UPON A SOLID FOUNDATION OF FINANCIAL STRENGTH BY FOCUSING ON SEVERAL CORE OBJECTIVES: UNDERWRITING PROFITABILITY; PRUDENT GROWTH; AND OPERATING EFFICIENCY.”

– 2002 ANNUAL REPORT

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Le Mars Insurance Company and Peninsula Insurance Group acquired

WritePro introduced as state-of-the-art personal lines underwriting and policy issuance system

DGI announces 4-for-3 stock split
Donegal enters acquisition rights agreement with Shelby Insurance Company for books of business in Alabama, Pennsylvania and Tennessee

WriteBiz introduced as new commercial lines automated underwriting system

DGI announces 4-for-3 stock split

DGI celebrates its twentieth year of growth and profitability with total revenues of \$330 million and stockholders' equity of \$321 million

Donegal named to Ward's 50 list of top performing insurance companies for second consecutive year

2004

2005

2006



Selected Consolidated Financial Data

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

*Per share information has been restated to reflect a 4-for-3 stock split effected in the form of a 33⅓% stock dividend on April 26, 2006.



2006

"WE CONTINUE TO STRIVE FOR SUPERIOR RESULTS, WHILE AT THE SAME TIME ADHERING TO THE CONSERVATIVE BUSINESS STRATEGIES THAT HAVE SERVED US WELL SINCE OUR INCEPTION."

Financial Information

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The Donegal Insurance Group was recognized for the second time in as many years by Ward Group, a Cincinnati-based management consulting firm specializing in the insurance industry. Ward Group named us to their listing of the top 50 performing insurance companies nationwide during 2006. Ward Group annually ranks 4,000 insurance companies in a number of safety, consistency and performance measurements over a five-year period, and we are pleased to have received this recognition as an independent attestation to our financial strength and performance.



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

General

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

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

On April 6, 2006, our board of directors approved a four-for-three stock split of our Class A common stock and our Class B common stock effected in the form of a 33⅓% stock dividend to stockholders of record at the close of business on April 17, 2006 and paid on April 26, 2006. The capital stock accounts, all share amounts and earnings per share amounts for 2005 and prior years have been restated to reflect this stock split.

On February 17, 2005, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33⅓% stock dividend with a record date of March 1, 2005 and a distribution date of March 28, 2005.

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

Pooling Agreement and Other Transactions with Affiliates

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

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

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

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

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

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

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

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

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

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

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

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

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

committee must conclude that the agreement or change is fair to Donegal Mutual and its policyholders.

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

Critical Accounting Policies and Estimates

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

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

Liability for Losses and Loss Expenses

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

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

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

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

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

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

medical loss cost trends and a general slowing of settlement rates in litigated claims. Further adjustments to our insurance subsidiaries' estimates could be required in the future. However, on the basis of our insurance subsidiaries' internal procedures, which analyze, among other things, their prior assumptions, their experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that our insurance subsidiaries have made adequate provision for their liability for losses and loss expenses.

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

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

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

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

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

⁽¹⁾ Net of income tax effect.

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

Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite. For personal lines products, our insurance subsidiaries insure standard and preferred risks in private passenger automobile and homeowners lines. For commercial lines products, the commercial risks that our insurance subsidiaries primarily insure are mercantile risks, business offices, wholesalers, service providers, contractors and artisan risks, limiting industrial and manufacturing exposures. Our insurance subsidiaries have limited exposure to asbestos and other environmental liabilities. Our insurance subsidiaries write no medical malpractice or professional liability risks. Through the consistent application of this disciplined underwriting philosophy, our insurance subsidiaries have avoided many of the "long-tail" issues faced by other insurance companies. We consider workers' compensation to be a "long-tail" line of business, in that workers' compensation claims tend to be settled over a longer timeframe

than those in our insurance subsidiaries' other lines of business. The following table presents 2006 and 2005 claim count and payment amount information for workers' compensation. Workers' compensation losses primarily consist of indemnity and medical costs for injured workers. Substantially all of the claims are relatively small individual claims of a similar type.

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

Investments

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

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

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

Policy Acquisition Costs

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

Management Evaluation of Operating Results

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

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

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

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

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

Results of Operations

Years Ended December 31, 2006 and 2005

Net Premiums Written

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

Net Premiums Earned

Our insurance subsidiaries' net premiums earned increased to \$301.5 million for 2006, an increase of \$7.0 million, or 2.4%, over 2005. Our insurance subsidiaries' net earned premiums during 2006 have grown due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of the policies issued by our insurance subsidiaries, which are generally one year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the same period one year earlier.

Investment Income

For 2006, our net investment income increased 15.1% to \$21.3 million, compared to \$18.5 million for 2005. An increase in our average invested assets from \$523.4 million in 2005 to \$569.5 million in 2006 primarily accounted for the increase in investment income in 2006 compared to 2005. Our annualized average return increased to 3.7% compared to 3.5% in 2005. The increase in our annualized average return reflects a shift from short-term investments to higher-yielding fixed maturities in our investment portfolio as well as higher short-term interest rates during 2006 compared to 2005. These increases were offset in part by decreases in our annualized average rate of return on our increased holdings of tax-exempt fixed maturities in our investment portfolio during 2006 compared to 2005. The increased holdings of tax-exempt fixed maturities in 2006 resulted from a shift from taxable to tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

Installment Payment Fees

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

Net Realized Investment Gains/Losses

Our net realized investment gains in 2006 and 2005 were \$1.8 million. Our net realized investment gains in 2006 were net of impairment charges of \$47,538, compared to impairment charges of \$409,432 recognized in 2005. Our impairment charges for both years were the result of declines in the market value of equity securities that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

Losses and Loss Expenses

Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in 2006 was 55.8%, compared to 56.9% in 2005. Our insurance subsidiaries' commercial lines loss ratio

decreased to 48.0% in 2006, compared to 53.0% in 2005. This decrease primarily resulted from the workers' compensation loss ratio decreasing to 53.4% in 2006, compared to 68.0% in 2005. The personal lines loss ratio increased slightly from 59.3% in 2005 to 60.7% in 2006, primarily as a result of an increase in the personal automobile loss ratio to 64.2% in 2006, compared to 62.4% in 2005, and an increase in the homeowners loss ratio to 57.4% in 2006, compared to 54.9% in 2005, as a result of an increase in weather-related claims. Our insurance subsidiaries' 2006 loss ratios reflect the benefits of decreased claim frequency and favorable prior accident year loss development of \$13.6 million in 2006, compared to favorable prior accident year loss development of \$9.4 million in 2005. Favorable prior accident year loss development in both years was largely due to favorable settlements of open claims.

Underwriting Expenses

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

Combined Ratio

Our insurance subsidiaries' combined ratio was 89.0% and 89.5% in 2006 and 2005, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned.

Interest Expense

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

Income Taxes

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

Net Income and Earnings Per Share

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

Book Value Per Share and Return on Equity

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

Results of Operations

Years Ended December 31, 2005 and 2004

Net Premiums Written

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

Net Premiums Earned

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

Investment Income

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

Installment Payment Fees

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

Net Realized Investment Gains/Losses

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

Losses and Loss Expenses

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

decreased to 53.0% in 2005, compared to 60.4% in 2004. This decrease primarily resulted from the workers' compensation loss ratio decreasing to 68.0% in 2005, compared to 87.2% in 2004. The personal lines loss ratio improved from 62.5% in 2004 to 59.3% in 2005, primarily as a result of improvement in the personal automobile loss ratio to 62.4% in 2005, compared to 65.5% in 2004, and improvement in the homeowners loss ratio to 54.9% in 2005, compared to 56.4% in 2004. Improvements in our insurance subsidiaries' 2005 loss ratios reflect the benefits of premium pricing increases, decreased claim frequency and favorable prior accident year loss development of \$9.4 million in 2005, compared to favorable prior accident year loss development of \$7.2 million in 2004. Favorable prior accident year loss development in both years was largely due to favorable settlements of open claims. The 2004 workers' compensation loss ratio was adversely impacted by reserve strengthening based upon past development trends in this line of business.

Underwriting Expenses

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

Combined Ratio

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

Interest Expense

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

Income Taxes

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

Net Income and Earnings Per Share

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

Book Value Per Share and Return on Equity

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

Financial Condition

Liquidity and Capital Resources

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

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

On May 24, 2004, we received \$5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2006, the interest rate on the debentures was 9.22%.

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year \$35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2006, we have the ability to borrow \$35.0 million at interest rates equal to M&T's current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The credit agreement requires our compliance with certain covenants, which include minimum levels of net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. During the years ended December 31, 2006 and 2005, no borrowings were outstanding, and we complied with all requirements of the credit agreement.

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

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

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

Dividends declared to stockholders totaled \$8.4 million, \$7.0 million and \$6.2 million in 2006, 2005 and 2004, respectively. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2006, our insurance subsidiaries' capital were each substantially above the RBC requirements. In 2007, amounts available for distribution as dividends to us without prior approval of their domiciliary insurance regulatory authorities are \$26.7 million from Atlantic States, \$2.5 million from Le Mars, \$3.3 million from Peninsula and \$5.9 million from Southern.

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

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

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

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

Investments

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

At December 31, 2006 and 2005, the carrying value of our fixed maturity investments represented 84.7% and 86.8% of our total invested assets, respectively.

Our fixed maturity investments consisted of high-quality marketable bonds, all of which were rated at investment-grade levels, at December 31, 2006 and 2005. As we invested excess cash from operations and proceeds from maturities of fixed-maturity investments during 2006, we increased our holdings of tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

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

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

Quantitative and Qualitative Disclosures About Market Risk

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

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

Interest Rate Risk

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

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 2006 are as follows:

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

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

Equity Price Risk

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

Credit Risk

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

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

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

Impact of Inflation

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

Impact of New Accounting Standards

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

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

Consolidated Balance Sheets

December 31,	2006	2005
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value \$168,423,464 and \$178,601,127)	\$169,178,137	\$180,182,305
Available for sale, at fair value (amortized cost \$330,435,311 and \$295,097,229)	331,669,778	295,097,235
Equity securities, available for sale, at fair value (cost \$33,505,531 and \$28,993,361)	40,541,826	33,371,360
Investments in affiliates	8,463,059	8,441,546
Short-term investments, at cost, which approximates fair value	41,484,874	30,653,668
Total investments	591,337,674	547,746,114
Cash	531,756	3,811,011
Accrued investment income	5,769,087	5,521,335
Premiums receivable	49,948,454	47,124,106
Reinsurance receivable	97,677,015	94,137,096
Deferred policy acquisition costs	24,738,929	23,476,593
Deferred tax asset, net	9,085,688	11,532,834
Prepaid reinsurance premiums	44,376,953	40,063,138
Property and equipment, net	5,146,305	5,234,423
Accounts receivable – securities	262,992	411,149
Federal income taxes recoverable	998,785	901,341
Other	1,824,173	1,462,448
Total assets	\$831,697,811	\$781,421,588
Liabilities and Stockholders' Equity		
Liabilities		
Losses and loss expenses	\$259,022,459	\$265,729,527
Unearned premiums	196,902,972	186,660,050
Accrued expenses	12,754,012	12,706,485
Reinsurance balances payable	2,034,972	1,814,292
Cash dividends declared to stockholders	2,442,958	1,781,393
Subordinated debentures	30,929,000	30,929,000
Accounts payable – securities	3,392,329	896,893
Due to affiliate	1,567,091	728,486
Drafts payable	381,744	703,912
Other	1,468,012	1,575,364
Total liabilities	510,895,549	503,525,402
Stockholders' Equity		
Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued	—	—
Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 19,834,248 and 19,156,169 shares and outstanding 19,689,318 and 19,011,268 shares	198,342	191,562*
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 5,649,240 and outstanding 5,576,775 shares	56,492	56,492*
Additional paid-in capital	152,391,301	141,932,954
Accumulated other comprehensive income	5,061,174	2,532,073
Retained earnings	163,986,701	134,074,853*
Treasury stock, at cost	(891,748)	(891,748)
Total stockholders' equity	320,802,262	277,896,186
Total liabilities and stockholders' equity	\$831,697,811	\$781,421,588

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

See accompanying notes to consolidated financial statements.

Consolidated Statements of Income and Comprehensive Income

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

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

See accompanying notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

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

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

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

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

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1 — Summary of Significant Accounting Policies

Organization and Business

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

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

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

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

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

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

Basis of Consolidation

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

Use of Estimates

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

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

Reclassification

Certain amounts in 2005 and 2004 as reported in the Consolidated Balance Sheets, Consolidated Statements of Cash Flows and Notes to Consolidated Financial Statements have been reclassified to conform to the current year presentation. The capital stock accounts, all share amounts and earnings per share amounts for 2005 and 2004 have been restated to reflect the four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33⅓% stock dividend to stockholders of record at the close of business April 17, 2006 and paid on April 26, 2006.

Investments

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

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

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

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

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

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

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

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

Fair Values of Financial Instruments

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

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

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

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

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

Revenue Recognition

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

Policy Acquisition Costs

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

Property and Equipment

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

Losses and Loss Expenses

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

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

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

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

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

Income Taxes

We currently file a consolidated federal income tax return.

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

Credit Risk

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

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

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

Reinsurance Accounting and Reporting

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

Stock-Based Compensation

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

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

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

Earnings per Share

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

2 — Impact of New Accounting Standards

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

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

3 — Transactions with Affiliates

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

a. Reinsurance Pooling and Other Reinsurance Arrangements

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b. Expense Sharing

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

c. Lease Agreement

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

d. Legal Services

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

e. Province Bank

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

4 — Business Combinations

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

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

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

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

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

5 — Investments

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

2006				
	Amortized	Gross	Gross	Estimated
Held to Maturity	Cost	Unrealized	Unrealized	Fair
		Gains	Losses	Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 58,094,402	\$ —	\$ 1,530,119	\$ 56,564,283
Obligations of states and political subdivisions	83,282,591	1,137,563	156,639	84,263,515
Corporate securities	14,637,949	240,144	97,186	14,780,907
Mortgage-backed securities	13,163,195	4,710	353,146	12,814,759
Totals	\$169,178,137	\$1,382,417	\$2,137,090	\$168,423,464

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

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

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

The amortized cost and estimated fair value of fixed maturities at December 31, 2006, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized	Estimated
	Cost	Fair
Held to maturity		Value
Due in one year or less	\$ 10,873,432	\$ 10,764,755
Due after one year through five years	59,982,055	58,784,265
Due after five years through ten years	56,158,392	56,997,995
Due after ten years	29,001,063	29,061,690
Mortgage-backed securities	13,163,195	12,814,759
Total held to maturity	\$169,178,137	\$168,423,464
Available for sale		
Due in one year or less	\$ 20,713,940	\$ 20,607,989
Due after one year through five years	51,873,365	51,938,988
Due after five years through ten years	114,622,676	115,420,716
Due after ten years	89,548,084	90,861,851
Mortgage-backed securities	53,677,246	52,840,234
Total available for sale	\$330,435,311	\$331,669,778

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

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

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

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

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

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

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

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

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

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2006 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 10,921,320	\$ 30,528	\$78,616,562	\$1,988,899
Obligations of states and political subdivisions	18,707,294	130,414	51,184,920	527,354
Corporate securities	3,004,951	2,348	10,764,265	214,084
Mortgage-backed securities	18,357,290	170,036	37,910,625	1,036,530
Equity securities	6,107,135	310,273	902,033	75,875
Totals	\$ 57,277,990	\$ 643,599	\$179,378,405	\$3,842,742

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

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

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

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

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

We have no derivative instruments or hedging activities.

6 — Deferred Policy Acquisition Costs

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

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

7 — Property and Equipment

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

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

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

8 — Liability for Losses and Loss Expenses

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

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

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

9 — Borrowings

Line of Credit

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year \$35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2006, we may borrow up to \$35.0 million at interest rates equal to M&T's current prime rate or the then current London Interbank Eurodollar bank rate (LIBOR) plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The credit agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best

ratings of our insurance subsidiaries. During the years ended December 31, 2006 and 2005, no borrowings were outstanding, and we complied with all requirements of the credit agreement.

Subordinated Debentures

On May 15, 2003, we received \$15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At December 31, 2006, the interest rate on these debentures was 9.47%, and is next subject to adjustment on February 15, 2007. As of December 31, 2006 and 2005, our consolidated balance sheets included an investment in a trust of \$464,000 and subordinated debentures of \$15.5 million related to this transaction.

On October 29, 2003, we received \$10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2006, the interest rate on these debentures was 9.23%, and is next subject to adjustment on January 29, 2007. As of December 31, 2006 and 2005, our consolidated balance sheets included an investment in a trust of \$310,000 and subordinated debentures of \$10.3 million related to this transaction.

On May 24, 2004, we received \$5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2006, the interest rate on these debentures was 9.22%, and is next subject to adjustment on February 24, 2007. As of December 31, 2006 and 2005, our consolidated balance sheets included an investment in a trust of \$155,000 and subordinated debentures of \$5.2 million related to this transaction.

10 — Reinsurance

Unaffiliated Reinsurers

Atlantic States, Southern and Donegal Mutual purchase third-party reinsurance on a combined basis. Le Mars and Peninsula have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with their requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of management, is equivalent to a company with at least an A-rating. The external reinsurance Atlantic States, Southern and Donegal Mutual purchase includes “excess of loss reinsurance,” under which their losses are automatically reinsured, through a series of contracts, over a set retention (\$400,000), and “catastrophic reinsurance,” under which they recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (\$3.0 million). Our insurance subsidiaries’ principal third party reinsurance agreement in 2006 was a multi-line per risk excess of loss treaty that provided 100% coverage up to \$1.0 million for both property and liability losses over the set retention. For property insurance, our insurance

subsidiaries also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$2.5 million per loss. For liability insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$40.0 million per occurrence. For workers’ compensation insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$5.0 million on any one life. Atlantic States, Southern and Donegal Mutual had property catastrophe coverage through a series of layered treaties up to aggregate losses of \$80.0 million for any single event. This coverage was provided through as many as 26 reinsurers on any one treaty with no reinsurer taking more than 22.5% of any one contract. The amount of coverage provided under each of these types of reinsurance depended upon the amount, nature, size and location of the risks being reinsured. Donegal Mutual and our insurance subsidiaries also purchased facultative reinsurance to cover exposures from losses that exceeded the limits provided by our respective treaty reinsurance. The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers during 2006, 2005 and 2004:

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

Total Reinsurance

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

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

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

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

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

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

11 — Income Taxes

The provision for income tax consists of the following:

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

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

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

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

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

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

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

12 — Stockholders' Equity

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

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

On February 17, 2005, our board of directors approved a four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33⅓% stock dividend to stockholders of record at the close of business on March 1, 2005 and paid on March 28, 2005.

On April 6, 2006, our board of directors approved a four-for-three stock split of our Class A common stock and our Class B common stock effected in the form of a 33⅓% stock dividend to stockholders of record at the close of business on April 17, 2006 and paid on April 26, 2006.

13 — Stock Compensation Plans

Equity Incentive Plans

During 1996, we adopted an equity incentive plan for employees. During 2001, we adopted a nearly identical plan that made a total of 2,666,667 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. During 2005, an amendment to the plan made a total of 4,000,000 shares of Class A common stock available for issuance. Each plan provides for the granting of awards by our board of directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. The plans provide that stock options may become exercisable up to 10 years from date of grant, with an option price not less than fair market value on date of grant. No stock appreciation rights have been issued.

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

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

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

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

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

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

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

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

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

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

Information regarding activity in our stock option plans follows:

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2003	2,629,968	\$ 6.59
Granted – 2004	61,333	10.60
Exercised – 2004	(1,051,256)	5.80
Forfeited – 2004	(53,045)	6.66
Outstanding at December 31, 2004	1,587,000	7.28
Granted – 2005	1,338,223	15.73
Exercised – 2005	(593,485)	7.42
Forfeited – 2005	(49,631)	15.52
Outstanding at December 31, 2005	2,282,107	12.02
Granted – 2006	1,055,667	20.98
Exercised – 2006	(601,869)	7.80
Forfeited – 2006	(52,078)	14.52
Outstanding at December 31, 2006	2,683,827	\$16.44
Exercisable at:		
December 31, 2004	1,214,967	\$ 7.30
December 31, 2005	981,069	\$ 7.13
December 31, 2006	824,681	\$11.32

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

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

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

Employee Stock Purchase Plans

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

The 2001 plan extends over a 10-year period and provides for shares to be offered to all eligible employees at a purchase price equal to the lesser of 85% of the fair market value of our Class A common stock on the last day before the first day of the enrollment period (June 1 and December 1) of the plan or 85% of the fair market value of our Class A common stock on the last day of the subscription period (June 30 and December 31). A summary of plan activity follows:

	Shares Issued	
	Price	Shares
January 1, 2004	\$ 6.44	13,577
July 1, 2004	9.57	8,905
January 1, 2005	9.89	10,788
July 1, 2005	10.28	11,445
January 1, 2006	11.77	10,763
July 1, 2006	15.45	9,531

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

Agency Stock Purchase Plans

During 1996, we adopted an agency stock purchase plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance. The 2001 plan provides for agents of our affiliated companies to invest up to \$12,000 per subscription period (April 1 to September 30 and October 1 to March 31) under various methods. Stock is issued at the end of the subscription period at a price equal to 90% of the average market price during the last ten trading days of the subscription period. During 2006, 2005 and 2004, 52,500, 58,201 and 58,349 shares, respectively, were issued under this plan. Expense recognized under the plan was not material.

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

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

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

	2006	2005	2004
Southern			
Statutory capital and surplus	\$ 62,201,936	\$ 56,802,771	\$ 50,253,802
Statutory unassigned surplus	\$ 13,084,350	\$ 7,685,185	\$ 1,136,217
Statutory net income	\$ 5,905,912	\$ 5,444,954	\$ 2,868,102

Le Mars

Statutory capital and surplus	\$ 25,415,894	\$ 21,386,553	\$ 17,103,902
Statutory unassigned surplus	\$ 12,823,154	\$ 8,793,813	\$ 4,511,162
Statutory net income	\$ 5,096,706	\$ 4,293,555	\$ 3,268,819

Peninsula

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

Our principal source of cash for payment of dividends are dividends from our insurance subsidiaries that are required by law to maintain certain minimum capital and surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are also subject to Risk Based Capital (RBC) requirements that may further impact their ability to pay dividends. At December 31, 2006, our insurance subsidiaries' statutory capital and surplus were substantially above the RBC requirements. Amounts available for distribution as dividends to us without prior approval of insurance regulatory authorities in 2007 are \$26,734,985 from Atlantic States, \$5,905,912 from Southern, \$2,541,589 from Le Mars and \$3,330,770 from Peninsula.

15 — Reconciliation of Statutory Filings to Amounts Reported Herein

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

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

	Year Ended December 31,		
	2006	2005	2004
Statutory net income of insurance subsidiaries	\$43,032,648	\$37,759,013	\$ 26,261,441
Adjustments:			
Deferred policy acquisition costs	1,262,336	1,218,833	6,033,995
Deferred federal income taxes	(1,085,320)	(583,857)	405,256
Salvage and subrogation recoverable	(167,000)	164,306	(112,182)
Consolidating eliminations and adjustments	(10,686,208)	(1,805,579)	(579,343)
Parent-only net income (loss)	7,858,266	196,781	(394,898)
Net income as reported herein	\$40,214,722	\$36,949,497	\$ 31,614,269
	December 31,		
	2006	2005	2004
Statutory capital and surplus of insurance subsidiaries	\$290,873,346	\$255,761,260	\$217,752,909
Adjustments:			
Deferred policy acquisition costs	24,738,929	23,476,593	22,257,760
Deferred federal income taxes	(6,271,094)	(3,751,776)	(3,855,261)
Salvage and subrogation recoverable	8,144,000	8,311,000	8,146,694
Non-admitted assets and other adjustments, net	1,117,248	837,567	1,121,225
Fixed maturities	1,574,902	694,311	6,207,157
Parent-only equity and other adjustments	625,271	(7,432,769)	(8,926,170)
Stockholders' equity as reported herein	\$320,802,602	\$277,896,186	\$242,704,314

16 — Supplementary Cash Flow Information

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

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

17 — Earnings Per Share

The following information illustrates the computation of net income, outstanding shares and earnings per share on both a basic and diluted basis for the years ended December 31, 2006, 2005 and 2004:

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

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

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

18 — Condensed Financial Information of Parent Company

Condensed Balance Sheets

(in thousands)

December 31,	2006	2005
Assets		
Fixed-maturity investments	\$ 6,957	\$ 4,192
Investment in subsidiaries/affiliates (equity method)	329,337	294,333
Short-term investments	15,029	9,431
Cash	1,114	938
Property and equipment	1,207	1,168
Other	1,215	1,110
Total assets	\$354,859	\$311,172

Liabilities and Stockholders' Equity

Liabilities		
Cash dividends declared to stockholders	\$ 2,443	\$ 1,781
Subordinated debentures	30,929	30,929
Other	685	566
Total liabilities	34,057	33,276
Stockholders' equity	320,802	277,896
Total liabilities and stockholders' equity	\$354,859	\$311,172

Condensed Statements of Income and Comprehensive Income

(in thousands)

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

(in thousands)

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

Condensed Statements of Cash Flows

(in thousands)

Year Ended December 31,	2006	2005	2004
Cash flows from operating activities:			
Net income	\$40,215	\$36,949	\$31,614
Adjustments:			
Equity in undistributed net income of subsidiaries	(32,356)	(36,753)	(32,009)
Other	546	4,446	731
Net adjustments	(31,810)	(32,307)	(31,278)
Net cash provided	8,405	4,642	336
Cash flows from investing activities:			
Net purchase of fixed maturities	(2,917)	—	(2,084)
Net sale (purchase) of short-term investments	(5,598)	(3,846)	41,974
Net purchase of property and equipment	(546)	(392)	(246)
Investment in subsidiaries	(200)	—	(45,216)
Other	208	215	334
Net cash used	(9,053)	(4,023)	(5,238)
Cash flows from financing activities:			
Cash dividends paid	(7,782)	(6,813)	(5,985)
Issuance of common stock	6,307	5,551	6,948
Issuance of subordinated debentures	—	—	5,155
Tax benefit on exercise of stock options	2,299	—	—
Net cash provided (used)	824	(1,262)	6,118
Net change in cash	176	(643)	1,216
Cash at beginning of year	938	1,581	365
Cash at end of year	\$ 1,114	\$ 938	\$ 1,581

19 — Segment Information

We have three reportable segments which consist of the investment function, the personal lines of insurance and the commercial lines of insurance. Using independent agents, our insurance subsidiaries market personal lines of insurance to individuals and commercial lines of insurance to small and medium-sized businesses.

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

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

Financial data by segment is as follows:

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

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

20 — Guaranty Fund and Other Insurance-Related Assessments

Our insurance subsidiaries accrue for guaranty fund and other insurance-related assessments in accordance with Statement of Position (SOP) 97-3, "Accounting by Insurance and Other Enterprises for Insurance-Related Assessments." SOP 97-3 provides guidance for determining when an entity should recognize a liability for guaranty fund and other insurance-related assessments, how to measure that liability and when an asset may be recognized for the recovery of such assessments through premium tax offsets or policy surcharges. Our insurance subsidiaries' liabilities for guaranty fund and other insurance-related assessments were \$3,033,692 and \$3,064,791 at December 31, 2006 and 2005, respectively. These liabilities included \$358,393 and \$361,192 related to surcharges collected by our insurance subsidiaries on behalf of regulatory authorities for 2006 and 2005, respectively.

21 — Interim Financial Data (unaudited)

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

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

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Donegal Group Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006 in conformity with U.S. generally accepted accounting principles.

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

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

KPMG LLP

Philadelphia, Pennsylvania

March 13, 2007

Management's Report on Internal Control Over Financial Reporting

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

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

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

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

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



Donald H. Nikolaus
President and Chief Executive Officer



Jeffrey D. Miller
Senior Vice President and Chief Financial Officer

March 13, 2007

Report of Independent Registered Public Accounting Firm

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

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

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

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

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

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

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 13, 2007 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Philadelphia, Pennsylvania

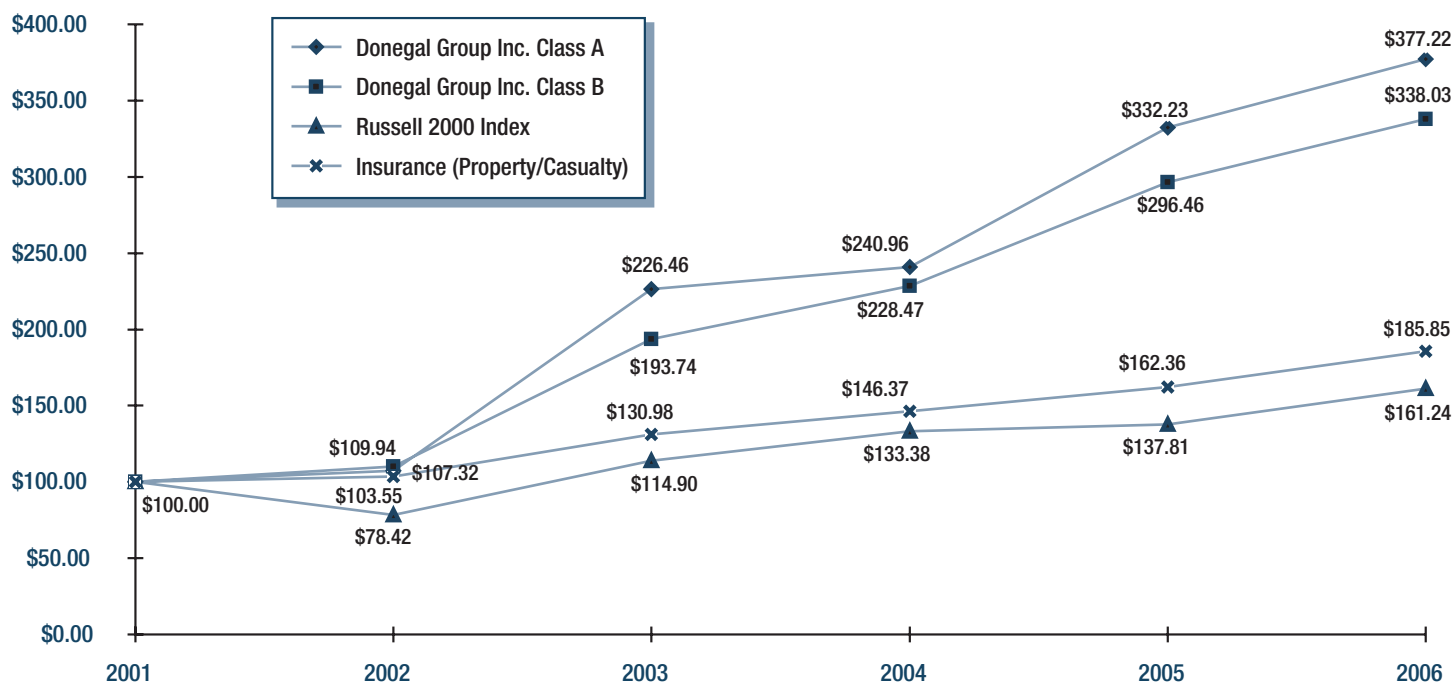
March 13, 2007

Comparison of Total Return on Our Common Stock with Certain Averages

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

Comparison of Five-Year Cumulative Total Return*

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



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

	2001	2002	2003	2004	2005	2006
Donegal Group Inc. Class A	100.00	107.32	226.46	240.96	332.23	377.22
Donegal Group Inc. Class B	100.00	109.94	193.74	228.47	296.46	338.03
Russell 2000 Index	100.00	78.42	114.90	133.38	137.81	161.24
Insurance (Property/Casualty)	100.00	103.55	130.98	146.37	162.36	185.85

*Cumulative total return assumes reinvestment of dividends.

Corporate Information

Annual Meeting

April 19, 2007 at the Company's headquarters
at 10:00 a.m.

Form 10-K

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

Market Information

Donegal Group's Class A common stock and Class B common stock are traded on the NASDAQ Global Select Market under the symbols "DGICA" and "DGICB." The following table shows the dividends paid per share and the stock price range for each quarter during 2006 and 2005:

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

*Restated for a 4-for-3 stock split

Corporate Offices

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

Transfer Agent

Computershare Trust Company, N.A.
P.O. Box 43078
Providence, Rhode Island 02940-3078
(800) 317-4445
Web Site: www.computershare.com
Hearing Impaired: TDD: 800-952-9245

Dividend Reinvestment and Stock Purchase Plan

The Company offers a dividend reinvestment and stock purchase plan through its transfer agent.
For information contact:
Donegal Group Inc.
Dividend Reinvestment and Stock Purchase Plan
Computershare Trust Company, N.A.
P.O. Box 43078
Providence, Rhode Island 02940-3078

Stockholders

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

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

Board of Directors and Officers

2006 ANNUAL REPORT

20 years

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
Jon M. Mahan	Director
S. Trezevant Moore, Jr.	Director
R. Richard Sherbahn	Director
Richard D. Wampler, II	Director

Officers

Donald H. Nikolaus	President and Chief Executive Officer
Jeffrey D. Miller	Senior Vice President and Chief Financial Officer
Sheri O. Smith	Secretary
Daniel J. Wagner	Senior Vice President and Treasurer

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
Scott A. Berlucchi	Director
Dennis J. Bixenman	Director
Frederick W. Dreher, III	Director
Patricia A. Gilmartin	Director
Cyril J. Greenya	Senior Vice President, Chief Underwriting Officer and a Director
John E. Hiestand	Director
Kevin M. Kraft, Sr.	Director
R. Richard Sherbahn	Director

Other Officers

Kevin G. Burke	Senior Vice President of Human Resources
Charles M. Ferraro	Senior Vice President and Chief Information Officer
Richard G. Kelley	Senior Vice President of Underwriting
Jeffrey D. Miller	Senior Vice President and Chief Financial Officer
Robert G. Shenk	Senior Vice President of Claims
William H. Shupert	Senior Vice President of Underwriting
Daniel J. Wagner	Senior Vice President and Treasurer
G. Eric Crouchley	Vice President
Kenneth L. Dull	Vice President of Research and Development
Jeffrey A. Jacobsen	Vice President of Personal Lines Underwriting
Perry S. Keith	Vice President of Internal Audit
Steven P. Klipa	Vice President of General Casualty Claims
David S. Krenkel	Vice President of Marketing and Advertising
W. Troy Martin	Vice President of Property Claims
Sheri O. Smith	Secretary
Chester J. Szczepanski	Vice President and Chief Actuary
Janet L. Weisberg	Vice President of Bodily Injury Claims





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