

RESULTS THROUGH MANAGED GROWTH



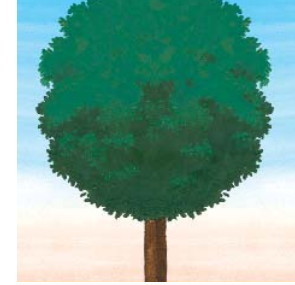
# Donegal Group

2005 ANNUAL REPORT

**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.

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



## MANAGED GROWTH



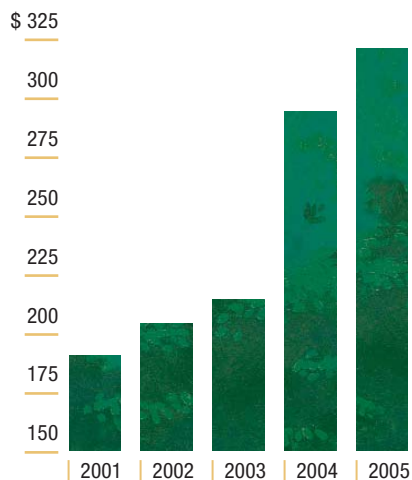
## 2005 ANNUAL REPORT

### Financial Highlights

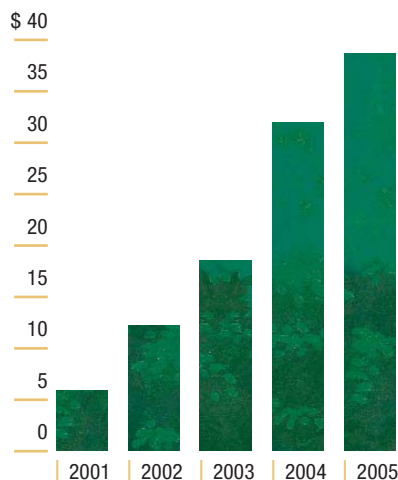
Year Ended December 31,	2001	2002	2003	2004	2005
<b>Income Statement Data</b>					
Premiums earned	\$167,769,854	\$185,841,193	\$196,792,696	\$265,838,594	\$294,498,023
Investment income	15,885,544	14,581,252	13,315,936	15,906,728	18,471,963
Total revenues	185,163,623	203,803,561	214,992,328	287,788,638	319,847,194
Net income	5,818,131	12,002,722	18,293,976	31,614,269	36,949,497
<b>Net income per common share</b>					
Basic earnings per common share	.49*	.99*	1.43*	1.80*	2.05
Diluted earnings per common share	.48*	.98*	1.39*	1.74*	1.98
<b>Balance Sheet Data</b>					
Total assets	\$456,632,372	\$501,218,164	\$602,036,042	\$735,415,401	\$781,421,588
Stockholders' equity	120,928,349	133,182,850	208,649,232	242,704,314	277,896,186
Book value per share	10.08*	10.89*	12.22*	13.53*	15.07

\*Restated to reflect a 4-for-3 stock split effected in the form of a 33⅓% stock dividend on March 28, 2005

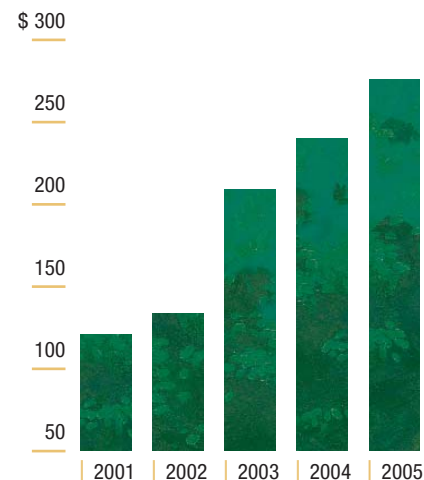
**Total Revenues** [ in millions ]



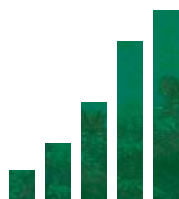
**Net Income** [ in millions ]



**Stockholders' Equity** [ in millions ]



## TO OUR STOCKHOLDERS AND FRIENDS



**We are very pleased to report that Donegal Group achieved record earnings for the fourth straight year. Our excellent underwriting profitability and earnings performance in 2005 reflect our pursuit of profitable growth, conservative risk selection and management of our exposure to catastrophic events.**

The insurance industry will long remember 2005 as the year of Katrina, by far the most costly hurricane in United States history. The year also set a new benchmark as having the most active hurricane and tropical storm season, with the number of named storms breaking the previous record set in 1933. We were fortunate that the effects of these storms were mostly confined to regions outside of our primary operating areas. We continue to carefully manage our catastrophe exposures and reinsurance program in an effort to limit the impact of catastrophic events on our operating results.

Our total revenues for 2005 were \$319,847,194, an 11.1 percent increase over the \$287,788,638 in revenues for 2004. Net income increased to a record \$36,949,497, or \$1.98 per share on a diluted basis, in 2005, compared to \$31,614,269, or \$1.74 per share on a diluted basis, in 2004. Record underwriting

profitability along with increased investment income accounted for the majority of the increase in our net income.

Our level of underwriting profitability, as measured by our combined ratio, continued our historical trend of significantly outperforming the property and casualty insurance industry as a whole. The combined ratio is the key measure of profitability from insurance underwriting and is a principal indicator of the levels of underwriting discipline and processing efficiency in the operations of an insurance company. Our 2005 GAAP combined ratio of 89.5 percent improved from the 93.1 percent combined ratio we posted in 2004. Our 2005 combined ratio outperformed the projected insurance industry average statutory combined ratio of 102 percent for 2005 by a wide margin. Our loss ratio decreased to 56.9 percent in 2005, compared to 61.7 percent in 2004, reflecting decreases in the relative number of bodily injury and weather-related claims. These decreases were the primary factor in our improved combined ratio.

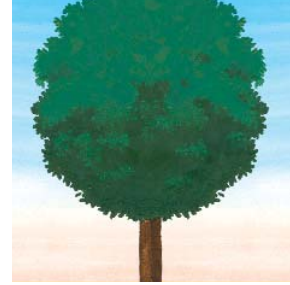
Our record earnings boosted our stockholders' equity to \$277,896,186 at year-end, representing an increase of 14.5 percent over year-end 2004. Likewise, our book value per share increased to \$15.07 per share at year-end, increasing 11.4 percent over our book value per share at December 31, 2004.

### In Memory

Mr. C. Edwin Ireland served as Director and Chairman of the Board of Donegal Group Inc. from 1986 until his retirement in 2002, when he was named Chairman Emeritus. Mr. Ireland was first elected as a Director of our affiliate, Donegal Mutual Insurance Company, in 1972. He was very supportive of the growth and strategic direction of the Donegal organization, and his leadership contributed greatly to our prosperity during his many years of service to our companies.



C. Edwin Ireland  
1909–2005



## 2005 ANNUAL REPORT

Ward Group, a Cincinnati-based management consulting firm specializing in the insurance industry, named us one of the top fifty performing insurance companies nationwide during 2005. Receiving a Ward's Benchmark 50 Award is a nationally recognized achievement. Our receipt of this award reflects five years of superior financial performance by the Donegal Insurance Group. Ward Group annually analyzes the financial performance of 4,000 insurance companies.

Recognizing that many factors have contributed to our successful year, we express our appreciation to the many independent agents who have joined us in our quest for profitable growth. We also acknowledge the critical importance of intellectual capital in our business and are grateful for the dedication and commitment of the employees working together to build our organization. In April 2005, we welcomed Jeffrey Miller as Chief Financial Officer of the Donegal Insurance Group and Sheri Smith as Secretary of the Donegal Insurance Group. Both of these individuals have served in other capacities within our organization, and we wish them success in their increased responsibilities.

We are saddened to report the death of C. Edwin Ireland on November 22, 2005. Mr. Ireland served as a Director and Chairman of the Board of Donegal Group from our inception in 1986 until his retirement in 2002. Mr. Ireland was a true friend to his fellow Directors and fulfilled his duties with exceptional dedication, excellence and integrity.

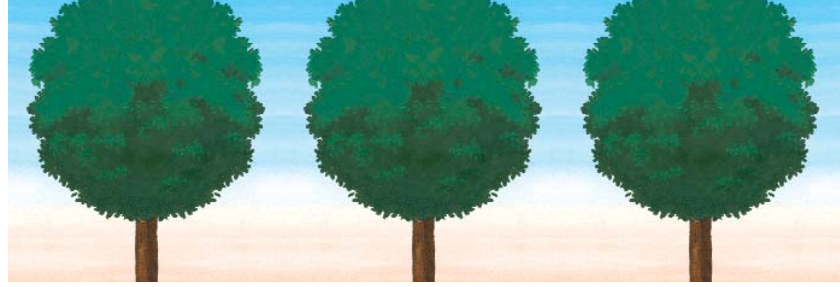
As we look forward to 2006 and beyond, we will continue to strive to manage our organization in a way that will enable us to produce successful results. The purchase of renewal rights from The Shelby Insurance Company as discussed further in the next section of our Annual Report will add to our growth in 2006 and represents another method we have available to us as we continue to pursue additional strategic acquisitions to bolster our growth.

We appreciate your support and trust, and we recognize that the enhancement of the value of our stockholders' investment over the long term is paramount to our mutual success.

Donald H. Nikolaus  
President

Philip H. Glatfelter II  
Chairman of the Board





## RESULTS THROUGH MANAGED GROWTH

At Donegal Group, 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. The Donegal Insurance Group, which includes the Donegal Group insurance companies and Donegal Mutual Insurance Company, was privileged to be ranked in 2005 among the top fifty performing insurance companies nationwide by Ward Group, a management consulting firm specializing in the insurance industry. The Ward's Benchmark 50 Award is presented to companies that excel in a number of safety, consistency and performance measurements over a five-year period. The analysis includes such metrics as average surplus, premium and net income levels and average returns on equity, assets and total revenue. We are pleased to have been selected to receive this award, and we recognize the importance of safety, consistency and performance in the accomplishment of our goals to build our organization and increase shareholder value over the long term.

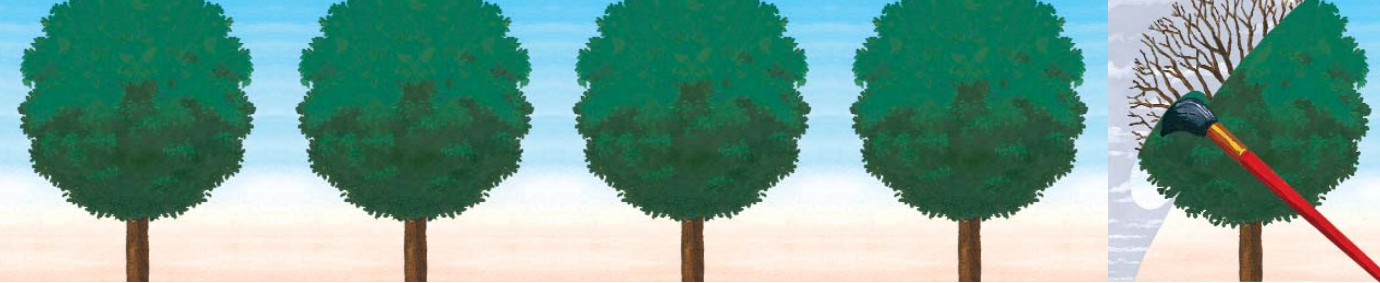


We have employed a multi-faceted strategy in the achievement of our growth objectives to date, and we remain committed to disciplined underwriting practices and the conservative management of our growth in order to maximize our profitability as we increase our premium base. Those familiar with our organization's history will recognize that our growth strategy has been consistent across the years, and the following pages provide an update to key components of that proven strategy – our regional emphasis, our utilization of technology and our pursuit of acquisitions.

### Regional Emphasis

We continue to follow a regional approach to the selling and servicing of our business, and our marketing regions have evolved over time as we have continued to expand our presence in new markets by increasing our base of agency representation, achieving brand awareness and proving ourselves as a market competitor.

Our Mid-Atlantic region includes the states of Pennsylvania, Maryland, Delaware and New York and continues to represent our largest concentration of business. In conjunction with our affiliate, Donegal Mutual Insurance Company, we entered into an agreement with The Shelby Insurance Company during 2005, wherein we agreed to purchase renewal rights to business in Pennsylvania, Alabama and Tennessee due to Shelby's



withdrawal from these states. We began to offer renewals on policies effective January 1, 2006, and are writing policies that meet our normal underwriting requirements. The Pennsylvania book of business represents the largest within the three states formerly serviced by Shelby, and we hope to achieve additional market penetration through this opportunity.

We have segmented a portion of our Southeast region into a distinct operating region, which we now refer to as our Virginia-Carolinas region. We continue to pursue growth within Virginia, where we have established a core book of business. As we move into 2006 and beyond, we will be emphasizing the growth of our premium writings in both North and South Carolina, working to create a market presence and recruit agents in communities where we believe we can obtain profitable growth in these states. We are servicing these states from our Virginia branch office and see significant growth potential in this region.

Our Southeast region now primarily includes Georgia, Tennessee and Alabama. We continue to enhance our product offerings and appoint new agents in this fast-growing region, and we are targeting this area for premium growth over the next several years. The acquisition of renewal rights to Shelby's Alabama and Tennessee books of business is expected to provide further critical mass in this region in 2006.

Our Midwest region includes Ohio, Iowa, Nebraska, South Dakota and Oklahoma. We continue to develop our market presence in Ohio, where we have been actively writing business for many years, and our 2004 acquisition of Le Mars Insurance Company has given us the opportunity to develop markets in other Midwest states. This region represents an area where we are interested in expanding by acquisition as the right opportunities arise.

## Marketing Regions

### Mid-Atlantic Region

Pennsylvania

Maryland

Delaware

New York

### Southeast Region

Georgia

Tennessee

Alabama

Louisiana

### Midwest Region

Ohio

Iowa

Nebraska

South Dakota

Oklahoma

### Virginia-Carolinas Region

Virginia

North Carolina

South Carolina

## A COMMITMENT TO PROFITABLE GROWTH



The popularity of our WritePro automated personal lines underwriting system has led to the development of WriteBiz, a web-based commercial lines underwriting system that enables our agents to quote and issue policies automatically.



### Enhanced Technology

We recognize the necessity of possessing and utilizing technology comparable to that of our largest competitors. "Ease of doing business" has become an increasingly important component of a carrier's value to an independent agency. We previously announced the implementation of our fully automated personal lines underwriting and policy issuance system, which we refer to as our "WritePro" system. Based upon feedback from our agents, we have steadily enhanced WritePro as we rolled the system out to agents in Pennsylvania, Virginia, Georgia and Ohio during 2005. The most recent enhancement to the system is a web-based user interface that greatly improves the ease of data entry and facilitates the quoting and issuance of policies for our agents.

Due to the positive response to our WritePro system, we have developed a commercial business counterpart, which we have named "WriteBiz." WriteBiz is an automated underwriting system that provides our agents with a similar web-based interface to automatically quote and issue commercial automobile, workers' compensation, business-owners and tradesman policies. WriteBiz





## ONE STRATEGIC STEP AT A TIME

2005 ANNUAL REPORT

utilizes the same rating engine as our internal underwriting system and incorporates our eligibility and underwriting guidelines. As a result, applications generated by our agents can be quickly transitioned to policies without further reentry of information, and policy information is then fully downloaded to our agent's policy management systems through our existing download capabilities. We are optimistic that this ease-of-processing enhancement will encourage our agents to direct more commercial business to us as this system is rolled out to our agency force in early 2006.

We have embarked on an extensive automation project to improve the efficiency of our claims service. Scheduled for implementation at the end of 2006, the ClaimsCenter system will employ web-based technology and electronic imaging to make many tasks easier and provide much efficiency in everyday claim handling. The system will be implemented for all lines of business at our home office, and we are planning to roll this technology out to a number of our branch office claim operations beginning in early 2007. We look forward to the increased service ability and cost efficiencies that this automation project will provide.

### Pursuit of Acquisitions

We are committed to finding acquisition opportunities that fit within a desired profile and our regional growth strategy. As we evaluate potential affiliations, we have a number of acquisition approaches available to us, including outright purchase (by cash or stock), purchase of a book of business, as well as mutual-to-mutual relationships facilitated through our affiliate, Donegal Mutual Insurance Company. We have employed a number of these methods in the past, with the acquisition of Shelby renewal rights being the latest example. We have developed experience in evaluating potential acquisitions through extensive due diligence and then, upon executing a deal, integrating acquisitions into our corporate family. While we continue to put a great deal of emphasis on organic growth, or growth obtained one policy at a time, our experience has shown that strategic acquisitions provide significant opportunities for profitable growth.

## Selected Consolidated Financial Data

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

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

## Financial Information

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

## General

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

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

On February 17, 2005, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33⅓% stock dividend with a record date of March 1, 2005 and a distribution date of March 28, 2005. The capital stock accounts, all share amounts and earnings per share amounts for 2004 and prior years have been restated to reflect this stock split.

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

## Pooling Arrangement and Other Transactions with Affiliates

In the mid-1980s, the Mutual Company, like a number of other mutual property and casualty insurance companies, recognized the need to develop additional sources of capital and surplus to remain competitive, have the capacity to expand its business and assure its long-term viability. The Mutual Company, again like a number of other mutual property and casualty insurance companies, determined to implement a downstream holding company structure as a strategic response. Thus, in 1986, the Mutual Company formed us as a downstream holding company, then wholly owned by the Mutual Company, and we formed Atlantic States as our wholly owned

subsidiary. As part of the implementation of this strategy, the Mutual Company and Atlantic States entered into a pooling agreement in 1986, whereby each company contributed all of its direct written business to the pool and the pool then allocated a portion of the pooled business to each company. The portion of the pooled business allocated to each company was commensurate with its capital and surplus and its capacity to obtain additional capital and surplus. The consideration to the Mutual Company for entering into the pooling agreement was its ownership of our capital stock and the expectation that the Mutual Company's surplus would increase over time as the value of its ownership interest in us increased.

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

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

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

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

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

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

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

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

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

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

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

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

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

## Critical Accounting Policies and Estimates

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

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

## Liability for Losses and Loss Expenses

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

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

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

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

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

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

Because of our participation in the pool with the Mutual Company, we are exposed to adverse loss development on the business of the Mutual Company that is included in the pool. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and the Mutual Company and we would proportionately share any adverse risk development of the pooled business. The business in the pool is homogenous (i.e., we have a 70% share of the entire pool and the Mutual Company has a 30% share of the entire pool). Since substantially all of the business of Atlantic States and the Mutual Company is pooled and the results shared by each company according to its participation level under

the terms of the pooling agreement, the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for each company than they would experience individually and to spread the risk of loss among each company.

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

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

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

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

<sup>(1)</sup> Net of income tax effect.

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

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

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

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

## Investments

We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in the value of our investments. When we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its estimated net realizable value, and the amount of the write-down is reflected as a realized loss in our statement of income. We individually monitor all investments for other than temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in an unrealized loss position for more than six months, we assume there has been an other than temporary decline in value. With respect to

debt securities, we assume there has been an other than temporary decline in value if it is probable that contractual payments will not be received. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including: the fair value of the investment being significantly below its cost, the deteriorating financial condition of the issuer of a security and the occurrence of industry, company and geographic events that have negatively impacted the value of a security or rating agency downgrades.

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

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

## Policy Acquisition Costs

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

## Management Evaluation of Operating Results

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

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

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

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

(in thousands)	Year Ended December 31,		
	2005	2004	2003
<b>Net premiums written:</b>			
Personal lines:			
Automobile	\$122,059	\$118,734	\$ 86,644
Homeowners	52,149	47,540	36,989
Other	10,620	9,882	6,753
<b>Total personal lines</b>	<b>184,828</b>	<b>176,156</b>	<b>130,386</b>
Commercial lines:			
Automobile	34,641	32,679	18,655
Workers' compensation	33,154	29,228	25,627
Commercial multi-peril	46,406	42,253	30,199
Other	3,515	2,966	2,114
<b>Total commercial lines</b>	<b>117,716</b>	<b>107,126</b>	<b>76,595</b>
<b>Total net premiums written</b>	<b>\$302,544</b>	<b>\$283,282</b>	<b>\$206,981</b>

<b>Components of GAAP combined ratio:</b>			
Loss ratio	56.9%	61.7%	64.2%
Expense ratio	32.1	30.9	30.2
Dividend ratio	0.5	0.5	0.6
<b>GAAP combined ratio</b>	<b>89.5%</b>	<b>93.1%</b>	<b>95.0%</b>

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

<b>Components of net income:</b>			
Underwriting income:			
Personal lines	\$ 14,232	\$ 10,100	\$ 2,004
Commercial lines	13,941	6,209	7,173
<b>SAP underwriting income</b>	<b>28,173</b>	<b>16,309</b>	<b>9,177</b>
GAAP adjustments	2,765	2,109	692
<b>GAAP underwriting income</b>	<b>30,938</b>	<b>18,418</b>	<b>9,869</b>
Net investment income	18,472	15,907	13,316
Realized investment gains	1,803	1,466	1,368
Other	1,132	1,263	883
<b>Income before income tax expense and extraordinary item</b>	<b>52,345</b>	<b>37,054</b>	<b>25,436</b>
Income tax expense	(15,396)	(10,886)	(7,142)
<b>Income before extraordinary item</b>	<b>36,949</b>	<b>26,168</b>	<b>18,294</b>
Extraordinary gain	—	5,446	—
<b>Net income</b>	<b>\$ 36,949</b>	<b>\$ 31,614</b>	<b>\$ 18,294</b>

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

### Net Premiums Written

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

### Net Premiums Earned

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

### Investment Income

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

### Installment Payment Fees

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

### Net Realized Investment Gains/Losses

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

### Losses and Loss Expenses

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



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

#### **Underwriting Expenses**

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

#### **Combined Ratio**

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

#### **Interest Expense**

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

#### **Income Taxes**

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

#### **Net Income and Earnings Per Share**

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

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

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

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

#### **Net Premiums Written**

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

#### **Net Premiums Earned**

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

#### **Investment Income**

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

#### **Installment Payment Fees**

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

#### **Net Realized Investment Gains/Losses**

Our net realized investment gains in 2004 were \$1.5 million, compared to \$1.4 million in 2003. Our net realized investment gains in 2004 were net of impairment charges of \$6,650, compared to impairment charges of \$237,724 recognized in 2003. Our impairment charges for both years were the result of declines in the market value of equity securities that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

#### **Losses and Loss Expenses**

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

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

### **Underwriting Expenses**

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

### **Combined Ratio**

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

### **Interest Expense**

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

### **Income Taxes**

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

### **Net Income and Earnings Per Share**

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

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

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

## **Financial Condition**

### **Liquidity and Capital Resources**

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

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

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

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

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

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

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

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

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

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

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

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

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

Le Mars operates as a multiple line carrier in Iowa, Nebraska, Oklahoma and South Dakota. Personal lines coverages represent a majority of premiums

written, with the balance coming from farmowners and mercantile and service businesses. Le Mars' largest lines of business are private passenger automobile liability and physical damage; other principal lines include homeowners and commercial multi-peril.

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

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

On February 17, 2005, our Board of Directors approved a four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33⅓% stock dividend to stockholders of record at the close of business March 1, 2005 and paid on March 28, 2005. The capital stock accounts, all share amounts and earnings per share amounts for 2004 and prior years have been restated to reflect this stock split.

### Investments

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

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

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

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

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

### Quantitative and Qualitative Disclosures About Market Risk

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

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

### Interest Rate Risk

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

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

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

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

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

#### Equity Price Risk

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

#### Credit Risk

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

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

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

#### Impact of Inflation

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

#### Impact of New Accounting Standards

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

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

# Consolidated Balance Sheets

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

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

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Income and Comprehensive Income

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

\*All 2004 and 2003 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 Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
	Class A Shares	Class B Shares	Class A Amount	Class B Amount					
Balance, January 1, 2003*	8,358,259	4,032,768	\$ 83,583	\$40,328	\$ 60,651,751	\$ 4,911,953	\$ 68,386,983	\$(891,748)	\$133,182,850
Issuance of common stock	4,729,333		47,293		60,193,670				60,240,963
Net income							18,293,976		18,293,976
Cash dividends							(4,372,154)		(4,372,154)
Exercise of stock options	85,884	36,092	859	361	744,310				745,530
Grant of stock options					976,077		(976,077)		—
Tax benefit on exercise of stock options					179,097				179,097
Other comprehensive income						378,970			378,970
Balance, December 31, 2003*	13,173,476	4,068,860	\$131,735	\$40,689	\$122,744,905	\$ 5,290,923	\$ 81,332,728	\$(891,748)	\$208,649,232
Issuance of common stock	64,982	377	650	3	859,945				860,598
Net income							31,614,269		31,614,269
Cash dividends							(6,174,867)		(6,174,867)
Exercise of stock options	621,313	167,129	6,213	1,672	6,081,938				6,089,823
Grant of stock options					87,259		(87,259)		—
Tax benefit on exercise of stock options					2,206,217				2,206,217
Other comprehensive loss						(540,958)			(540,958)
Balance, December 31, 2004*	13,859,771	4,236,366	\$138,598	\$42,364	\$131,980,264	\$ 4,749,965	\$106,684,871	\$(891,748)	\$242,704,314
Issuance of common stock	63,126		631		1,149,992				1,150,623
Net income							36,949,497		36,949,497
Cash dividends							(7,027,541)		(7,027,541)
Exercise of stock options	444,447	667	4,444	6	4,395,808				4,400,258
Grant of stock options					2,469,963		(2,469,963)		—
Tax benefit on exercise of stock options					1,936,927				1,936,927
Other comprehensive loss						(2,217,892)			(2,217,892)
Balance, December 31, 2005	14,367,344	4,237,033	\$143,673	\$42,370	\$141,932,954	\$ 2,532,073	\$134,136,864	\$(891,748)	\$277,896,186

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

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Cash Flows

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

See accompanying notes to consolidated financial statements.



# Notes to Consolidated Financial Statements

## 1 — Summary of Significant Accounting Policies

### Organization and Business

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

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

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

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

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

### Basis of Consolidation

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

### Use of Estimates

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

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

### Reclassification

Certain amounts as reported in the Consolidated Balance Sheets, Consolidated Statements of Cash Flows and Notes to Consolidated Financial Statements in 2004 and 2003 have been reclassified to conform to the current year presentation. The capital stock accounts, all share amounts and earnings per share amounts for 2004 and 2003 have been restated to reflect the four-for-three split of our Class A common stock and our Class B common stock effected in the form of a 33⅓% stock dividend to stockholders of record at the close of business March 1, 2005 and paid on March 28, 2005.

## Investments

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

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

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

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

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

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

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

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

## Fair Values of Financial Instruments

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

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

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

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

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

## Revenue Recognition

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

## Policy Acquisition Costs

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

## Property and Equipment

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

## Losses and Loss Expenses

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

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

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

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

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

#### Guaranty Fund Liability Accruals

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

#### Income Taxes

We currently file a consolidated federal income tax return.

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

#### Credit Risk

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

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

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

#### Reinsurance Accounting and Reporting

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

#### Stock-Based Compensation

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

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

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

	2005	2004	2003
Net income, as reported	\$36,949,497	\$31,614,269	\$18,293,976
Less:			
Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	(66,427)	(18,657)	(12,092)
Pro forma net income	\$36,883,070	\$31,595,612	\$18,281,884
Basic earnings per share:			
As reported	\$ 2.05	\$ 1.80	\$ 1.43
Pro forma	2.04	1.80	1.43
Diluted earnings per share:			
As reported	\$ 1.98	\$ 1.74	\$ 1.39
Pro forma	1.98	1.74	1.39

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

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

### Earnings per Share

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

## 2 — Impact of New Accounting Standards

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

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

## 3 — Transactions with Affiliates

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

### a. Reinsurance Pooling and Other Reinsurance Arrangements

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### b. Expense Sharing

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

#### c. Lease Agreement

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

#### d. Legal Services

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

#### e. Province Bank

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

### 4 — Business Combinations

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

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

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

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

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

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

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

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

(\$ in thousands, except per share data)

Total revenues	\$266,778
Income before income tax expense and extraordinary item	26,542
Income tax expense	7,530
Income before extraordinary item	19,012
Basic earnings per share before extraordinary item	1.27
Diluted earnings per share before extraordinary item	1.23

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

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

## 5 — Investments

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

	2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Held to Maturity</b>				
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
<b>Totals</b>	<b>\$180,182,305</b>	<b>\$1,512,471</b>	<b>\$3,093,649</b>	<b>\$178,601,127</b>

	2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>Available for Sale</b>				
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
<b>Totals</b>	<b>\$324,090,590</b>	<b>\$7,422,554</b>	<b>\$3,044,549</b>	<b>\$328,468,595</b>

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

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

The amortized cost and estimated fair value of fixed maturities at December 31, 2005, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
<b>Held to maturity</b>		
Due in one year or less	\$ 7,260,454	\$ 7,206,281
Due after one year through five years	69,024,386	67,352,944
Due after five years through ten years	27,600,418	27,848,545
Due after ten years	61,014,577	61,370,825
Mortgage-backed securities	15,282,470	14,822,532
<b>Total held to maturity</b>	<b>\$180,182,305</b>	<b>\$178,601,127</b>
<b>Available for sale</b>		
Due in one year or less	\$ 17,906,067	\$ 17,802,962
Due after one year through five years	50,945,588	50,832,558
Due after five years through ten years	108,369,339	108,743,994
Due after ten years	73,485,803	74,162,230
Mortgage-backed securities	44,390,432	43,555,491
<b>Total available for sale</b>	<b>\$295,097,229</b>	<b>\$295,097,235</b>

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

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

	2005	2004
DFSC	\$7,512,546	\$7,935,741
Other	929,000	929,000
<b>Total</b>	<b>\$8,441,546</b>	<b>\$8,864,741</b>

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

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

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

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

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

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

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

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

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

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

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

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

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

We have no derivative instruments or hedging activities.

## 6 — Deferred Policy Acquisition Costs

Changes in deferred policy acquisition costs are as follows:

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

## 7 — Property and Equipment

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

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

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

## 8 — Liability for Losses and Loss Expenses

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



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

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

## 9 — Borrowings

### Line of Credit

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

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

### Subordinated Debentures

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

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

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

## 10 — Reinsurance

### Unaffiliated Reinsurers

Atlantic States, Southern and the Mutual Company purchase third-party reinsurance on a combined basis. Le Mars and Peninsula have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. We use several different reinsurers, all of which, consistent with our requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating. The external reinsurance Atlantic States, Southern and the Mutual Company purchase includes "excess of loss reinsurance," under which our losses are automatically reinsured, through a series of contracts, over a set retention (\$400,000 and \$300,000 retention for 2005 and 2004, respectively, with us having a 10% participation for losses up to \$1.0 million and \$300,000 for 2003), and "catastrophic reinsurance," under which we recover, through a series of contracts, between 95% and 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (\$3.0 million). Our principal third party reinsurance agreement was a multi-line per risk excess of loss treaty that provided 90% coverage up to \$1.0 million for both property and liability losses. For property insurance, we also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$2.5 million per loss. For liability insurance, we

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

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

#### Total Reinsurance

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

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

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

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

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

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

## 11 — Income Taxes

The provision for income tax consists of the following:

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

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

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

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

	2005	2004
Deferred tax assets:		
Unearned premium	\$10,270,793	\$ 9,708,475
Loss reserves	6,551,470	6,916,375
Net operating loss carryforward - acquired companies	4,376,784	4,824,300
Other	1,178,323	1,119,355
Total gross deferred assets	22,377,370	22,568,505
Less valuation allowance	(770,799)	(770,799)
Net deferred tax assets	21,606,571	21,797,706
Deferred tax liabilities:		
Depreciation expense	280,477	316,035
Deferred policy acquisition costs	8,216,807	7,790,216
Salvage recoverable	213,031	211,342
Net unrealized gains	1,363,422	2,557,673
Total gross deferred liabilities	10,073,737	10,875,266
Net deferred tax asset	\$11,532,834	\$10,922,440

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

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

## 12 — Stockholders' Equity

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

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

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

## 13 — Stock Compensation Plans

### Equity Incentive Plans

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

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

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

Information regarding activity in our stock option plans follows:

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

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

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

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

### Employee Stock Purchase Plans

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

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

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

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

#### Agency Stock Purchase Plans

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

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

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

	2005	2004	2003
<b>Atlantic States</b>			
Statutory capital and surplus	\$ 148,521,462	\$ 127,219,109	\$ 109,854,398
Statutory unassigned surplus	\$ 94,860,598	\$ 73,558,245	\$ 56,193,534
Statutory net income	\$ 21,855,006	\$ 16,342,671	\$ 13,272,651

#### Southern

Statutory capital and surplus	\$ 56,802,771	\$ 50,253,802	\$ 40,649,495
Statutory unassigned surplus (deficit)	\$ 7,685,185	\$ 1,136,217	\$ (1,968,090)
Statutory net income	\$ 5,444,954	\$ 2,868,102	\$ 5,275,909

#### Le Mars

Statutory capital and surplus	\$ 21,386,553	\$ 17,103,902	\$ 11,987,214
Statutory unassigned surplus	\$ 8,793,813	\$ 4,511,162	\$ 7,987,214
Statutory net income (loss)	\$ 4,293,555	\$ 3,268,819	\$ (728,329)

#### Peninsula

Statutory capital and surplus	\$ 29,050,474	\$ 23,176,096	\$ 19,477,027
Statutory unassigned surplus	\$ 11,251,060	\$ 5,576,682	\$ 3,125,533
Statutory net income	\$ 6,165,498	\$ 3,781,849	\$ 1,513,794

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

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

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

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

	Year Ended December 31,		
	2005	2004	2003
Statutory net income of insurance subsidiaries	\$37,759,013	\$ 26,261,441	\$ 18,548,560
Adjustments:			
Deferred policy acquisition costs	1,218,833	6,033,995	1,656,695
Deferred federal income taxes	(583,857)	405,256	352,731
Salvage and subrogation recoverable	164,306	(112,182)	(167,627)
Consolidating eliminations and adjustments	(1,805,579)	(579,343)	(8,099,197)
Parent-only net income (loss)	196,781	(394,898)	6,002,814
Net income as reported herein	\$36,949,497	\$ 31,614,269	\$ 18,293,976
		December 31,	
	2005	2004	2003
Statutory capital and surplus of insurance subsidiaries	\$255,761,260	\$217,752,909	\$150,503,893
Adjustments:			
Deferred policy acquisition costs	23,476,593	22,257,760	16,223,765
Deferred federal income taxes	(3,751,776)	(3,855,261)	(4,268,453)
Salvage and subrogation recoverable	8,311,000	8,146,694	7,167,008
Non-admitted assets and other adjustments, net	837,567	1,121,225	907,955
Fixed maturities	694,311	6,207,157	6,521,246
Parent-only equity and other adjustments	(7,432,769)	(8,926,170)	31,593,818
Stockholders' equity as reported herein	\$277,896,186	\$242,704,314	\$208,649,232

## 16 — Supplementary Cash Flow Information

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

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

## 17 — Earnings Per Share

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

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

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

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

## 18 — Condensed Financial Information of Parent Company

### Condensed Balance Sheets

(in thousands)

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

## Condensed Statements of Income and Comprehensive Income

(in thousands)

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

### Condensed Statements of Cash Flows

(in thousands)

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

## 19 — Segment Information

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

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

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

Financial data by segment is as follows:

	2005	2004	2003
(in thousands)			
<b>Revenues</b>			
Premiums earned:			
Commercial lines	\$112,711	\$ 99,657	\$ 71,471
Personal lines	181,787	169,322	125,322
Total SAP premiums earned	294,498	268,979	196,793
GAAP adjustments	—	(3,140)	—
Total GAAP premiums earned	294,498	265,839	196,793
Net investment income	18,472	15,907	13,316
Realized investment gains	1,803	1,466	1,368
Other	5,074	4,577	3,515
<b>Total revenues</b>	<b>\$319,847</b>	<b>\$287,789</b>	<b>\$214,992</b>
	2005	2004	2003
(in thousands)			
<b>Income before income taxes and extraordinary item:</b>			
Underwriting income:			
Commercial lines	\$13,941	\$ 6,209	\$ 7,173
Personal lines	14,232	10,100	2,004
SAP underwriting income	28,173	16,309	9,177
GAAP adjustments	2,765	2,109	692
GAAP underwriting income	30,938	18,418	9,869
Net investment income	18,472	15,907	13,316
Realized investment gains	1,803	1,466	1,368
Other	1,132	1,263	883
<b>Income before income tax expense and extraordinary item</b>	<b>\$52,345</b>	<b>\$37,054</b>	<b>\$25,436</b>

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

We accrue for guaranty fund and other insurance-related assessments in accordance with SOP 97-3, "Accounting by Insurance and Other Enterprises for Insurance-Related Assessments." SOP 97-3 provides guidance for determining when an entity should recognize a liability for guaranty fund and other insurance-related assessments, how to measure that liability and when an asset may be recognized for the recovery of such assessments

through premium tax offsets or policy surcharges. Our liabilities for guaranty fund and other insurance-related assessments were \$3,064,791 and \$4,140,878 at December 31, 2005 and 2004, respectively. These liabilities included \$361,192 and \$376,428 related to surcharges collected by us on behalf of regulatory authorities for 2005 and 2004, respectively.

## 21 — Interim Financial Data (unaudited)

	2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$71,762,523	\$73,438,090	\$74,584,045	\$74,713,365
Total revenues	78,079,058	79,492,080	80,566,455	81,709,601
Net losses and loss expenses	41,537,896	39,807,658	41,071,801	45,124,542
Net income	8,417,088	8,903,275	9,777,157	9,851,977
Net income per common share:				
Basic	0.47	0.50	0.54	0.54
Diluted	0.46	0.48	0.52	0.52
	2004			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$62,699,478	\$65,498,402	\$67,958,382	\$69,682,332
Total revenues	68,001,661	70,692,422	73,613,653	75,480,902
Net losses and loss expenses	40,371,057	39,961,021	42,285,455	41,523,835
Income before extraordinary item	6,286,636	6,770,187	5,886,886	7,224,890
Extraordinary item	5,445,670	—	—	—
Net income	11,732,306	6,770,187	5,886,886	7,224,890
Basic earnings per common share:				
Income before extraordinary item	0.37	0.39	0.33	0.41
Extraordinary item	0.31	—	—	—
Net income	0.68	0.39	0.33	0.41
Diluted earnings per common share:				
Income before extraordinary item	0.35	0.37	0.32	0.40
Extraordinary item	0.30	—	—	—
Net income	0.65	0.37	0.32	0.40

# Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

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

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

**KPMG LLP**

Philadelphia, Pennsylvania

March 13, 2006

# Management's Report on Internal Control Over Financial Reporting

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

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

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

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

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



Donald H. Nikolaus  
President and Chief Executive Officer



Jeffrey D. Miller  
Senior Vice President and Chief Financial Officer

March 13, 2006



# Report of Independent Registered Public Accounting Firm

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

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

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

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

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

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

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005, and our report dated March 13, 2006 expressed an unqualified opinion on those consolidated financial statements.

**KPMG LLP**

Philadelphia, Pennsylvania

March 13, 2006

## CORPORATE INFORMATION

### Annual Meeting

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

### Form 10-K

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

### Market Information

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

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

### Corporate Offices

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

### Transfer Agent

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

### Dividend Reinvestment and Stock Purchase Plan

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

### Stockholders

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

Class A common stock	785
Class B common stock	446



## BOARD OF DIRECTORS AND OFFICERS

2005 ANNUAL REPORT

### Donegal Group Inc.

<b>Board of Directors</b>	Donald H. Nikolaus	President, Chief Executive Officer and a Director
	Philip H. Glatfelter II	Chairman of the Board and a Director
	Robert S. Bolinger	Director
	Patricia A. Gilmartin	Director
	John J. Lyons	Director
	R. Richard Sherbahn	Director
	Richard D. Wampler II	Director

<b>Officers</b>	Donald H. Nikolaus	President and Chief Executive Officer
	Philip H. Glatfelter II	Chairman of the Board
	Jeffrey D. Miller	Senior Vice President and Chief Financial Officer
	Daniel J. Wagner	Senior Vice President and Treasurer
	Matthew T. Resch	Vice President of Investments and Investor Relations
	Sheri O. Smith	Secretary

### Donegal Mutual Insurance Company

<b>Board of Directors</b>	Donald H. Nikolaus	President, Chief Executive Officer and a Director
	Philip H. Glatfelter II	Chairman of the Board and a Director
	Frederick W. Dreher III	Director
	Patricia A. Gilmartin	Director
	John E. Hiestand	Director
	Kevin M. Kraft Sr.	Director
	R. Richard Sherbahn	Director
William H. Shupert	Senior Vice President of Underwriting and a Director	

<b>Other Officers</b>	Kevin G. Burke	Senior Vice President of Human Resources
	Charles M. Ferraro	Senior Vice President and Chief Information Officer
	Cyril J. Greenya	Senior Vice President and Chief Underwriting 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
	Daniel J. Wagner	Senior Vice President and Treasurer
	G. Eric Crouchley III	Vice President
	Kenneth L. Dull	Vice President of Research and Development
	Theodore A. Hoover	Vice President
	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
	Matthew T. Resch	Vice President of Investments
	David G. Simmons	Vice President of Sales and Business Development
	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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