WASHINGTON REAL ESTATE INVESTMENT TRUST
Form 4
March 02, 2012

FORM 4

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

OMB APPROVAL
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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
MCKENZIE GEORGE F

(Last) (First) (Middle)

6110 EXECUTIVE BOULEVARD, SUITE 800

(Street)

ROCKVILLE, MD 20852

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
WASHINGTON REAL ESTATE INVESTMENT TRUST [WRE]

3. Date of Earliest Transaction (Month/Day/Year)
02/29/2012

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
President, CEO & Director

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	02/29/2012		S		3,016	D	$ 30	141,503.299	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
MCKENZIE GEORGE F 6110 EXECUTIVE BOULEVARD, SUITE 800 ROCKVILLE, MD 20852	X		President, CEO & Director	

Signatures

By: Thomas C. Morey For: George F. McKenzie	03/02/2012
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. SIZE="1"> 2,283,860 (2,283,860)

Purchase of treasury stock

(1,537,587) (1,537,587)

Other comprehensive income

14,972,361 14,972,361

Balance, December 31, 2011								
20,752,999	5,649,240	$207,530	$56,492	$170,836,943	$23,533,447	$199,604,700	$(10,787,520)	$383,451,592

Explanation of Responses:

Explanation of Responses:

See accompanying notes to consolidated financial statements.

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Donegal Group Inc.

Consolidated Statements of Cash Flows

	Years Ended December 31,		
	2011	**2010**	**2009**
Cash Flows from Operating Activities:			
Net income	$ 452,953	$ 11,467,179	$ 18,830,078
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,106,561	3,143,767	2,552,186
Net realized investment gains	(12,281,267)	(4,395,720)	(4,479,558)
Equity (income) loss	(2,023,127)	268,341	(471,097)
Changes in Assets and Liabilities:			
Losses and loss expenses	59,088,943	14,904,770	23,789,568
Unearned premiums	39,665,100	21,762,781	12,807,490
Accrued expenses	(330,857)	718,956	(3,571,059)
Premiums receivable	(8,247,378)	(7,478,337)	(5,849,751)
Deferred policy acquisition costs	(1,979,376)	(1,601,400)	(3,302,898)
Deferred income taxes	(5,922,491)	(2,380,430)	(1,250,187)
Reinsurance receivable	(35,987,161)	(5,348,447)	(4,717,038)
Accrued investment income	652,133	(489,244)	452,796
Amounts due to/from affiliate	2,460,287	(887,190)	665,237
Reinsurance balances payable	899,017	(320,278)	994,610
Prepaid reinsurance premiums	(17,084,247)	(8,270,621)	(4,604,241)
Current income taxes	(1,713,483)	(368,145)	1,927,881
Other, net	(674,296)	1,278,821	323,491
Net adjustments	20,628,358	10,537,624	15,267,430
Net cash provided by operating activities	21,081,311	22,004,803	34,097,508
Cash Flows from Investing Activities:			
Purchase of fixed maturities:			
Available for sale	(189,111,596)	(195,198,227)	(158,409,231)
Purchase of equity securities:	(23,857,802)	(59,191,998)	(39,163,607)
Sale of fixed maturities			
Available for sale	122,873,102	72,092,788	62,668,210
Maturity of fixed maturities:			
Held to maturity	5,888,236	8,649,275	25,617,925
Available for sale	53,763,701	80,116,222	48,363,915
Sale of equity securities	27,036,422	70,029,195	39,638,895
Payments to Sheboygan policyholders			(6,526,527)
Purchase of MICO	(7,207,471)	(35,088,228)	
Net increase in investment in affiliates	(20,570,000)		(100,000)
Net purchase of property and equipment	(238,538)	(651,160)	(941,020)
Net sales of short-term investments	314,583	16,052,089	15,852,054
Net cash used in investing activities	(31,109,363)	(43,190,044)	(12,999,386)
Cash Flows from Financing Activities:			
Issuance of common stock	1,460,543	1,199,422	1,386,037
Cash dividends paid	(11,874,367)	(11,405,268)	(10,997,571)
Purchase of treasury stock	(1,537,587)	(145,687)	(393,644)

Payments on line of credit	(3,617,371)		
Borrowings under line of credit	22,500,000	34,955,088	
Net cash provided by financing activities	6,931,218	24,603,555	(10,005,178)
Net (decrease) increase in cash	(3,096,834)	3,418,314	11,092,944
Cash at beginning of year	16,342,212	12,923,898	1,830,954
Cash at end of year	$ 13,245,378	$ 16,342,212	$ 12,923,898

See accompanying notes to consolidated financial statements.

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Donegal Group Inc.

Notes to Consolidated Financial Statements

1 - Summary of Significant Accounting Policies

Organization and Business

Donegal Mutual Insurance Company (Donegal Mutual) organized us as an insurance holding company on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company (Atlantic States), Southern Insurance Company of Virginia (Southern), Le Mars Insurance Company (Le Mars), the Peninsula Insurance Group (Peninsula), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, Sheboygan Falls Insurance Company (Sheboygan) and Michigan Insurance Company (MICO), write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in certain Mid-Atlantic, Midwestern, New England and Southern states. We acquired MICO on December 1, 2010, and we have included MICO s results of operations in our consolidated results of operations since that date. We have three operating segments: our investment function, our personal lines of insurance and our commercial lines of insurance. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers compensation policies. We also own 48.2% of the outstanding stock of Donegal Financial Services Corporation (DFSC), a thrift holding company that owns Union Community Bank FSB (UCB). Donegal Mutual owns the remaining 51.8% of the outstanding stock of DFSC.

At December 31, 2011, Donegal Mutual held approximately 39% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock, which provide Donegal Mutual with 66% of the total voting power of our common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While each company maintains its separate corporate existence, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

Atlantic States, our largest subsidiary, participates in a pooling agreement with Donegal Mutual. Under the pooling agreement, the two companies pool their insurance business and each company receives an allocated percentage of the pooled business. Atlantic States has an 80% share of the results of the pooled business, and Donegal Mutual has a 20% share of the results of the pooled business. The risk profiles of the business Atlantic States and Donegal Mutual write have historically been, and continue to be, substantially similar.

The same executive management and underwriting personnel administer products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries. In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products our insurance subsidiaries and Donegal Mutual market are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group s ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but we do not allocate all of the standard risk gradients to one company. Therefore, the underwriting profitability of the business the individual companies write directly will vary. However, as the risk characteristics of all business Donegal Mutual and Atlantic States write directly are homogenized within the underwriting pool, Donegal Mutual and Atlantic States share the underwriting results in proportion to their respective participation in the pool. Pooled business represents the predominant percentage of the net underwriting activity of both Donegal Mutual and Atlantic States. We refer to Note 3 - Transactions with Affiliates for more information regarding the pooling agreement.

In October 2009, Donegal Mutual consummated an affiliation with Southern Mutual Insurance Company (Southern Mutual), pursuant to which Donegal Mutual purchased a surplus note of Southern Mutual in the principal amount of $2.5 million, Donegal Mutual designees became a majority of the members of Southern Mutual s board of directors and Donegal Mutual agreed to provide quota-share reinsurance to Southern Mutual for 100% of its business. Effective October 31, 2009, Donegal Mutual began to include business assumed from Southern Mutual in its pooling agreement with Atlantic States. Southern Mutual writes primarily personal lines of insurance in Georgia and South Carolina and had direct written premiums of approximately $13.9 million and $12.8 million in 2011 and 2010, respectively. Pursuant to applicable accounting standards, Southern Mutual is a variable interest entity, of which we are not the primary beneficiary.

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In December 2010, we acquired MICO, which had been a majority-owned subsidiary of West Bend Mutual Insurance Company (West Bend) for $42.3 million in cash. MICO writes various lines of property and casualty insurance and had direct written premiums of $108.0 million and $105.4 million in 2011 and 2010, respectively. MICO had net written premiums of $27.1 million in each of 2011 and 2010. Effective on December 1, 2010, MICO entered into a 50% quota-share agreement with third-party reinsurers and a 25% quota-share reinsurance agreement with Donegal Mutual to replace the 75% quota-share reinsurance agreement MICO maintained with West Bend through November 30, 2010.

In May 2011, DFSC merged with Union National Financial Corporation (UNNF), with DFSC as the surviving company in the merger. Under the merger agreement, Province Bank FSB, which DFSC owned, and Union National Community Bank, which UNNF owned, also merged and began doing business as UCB. Donegal Mutual contributed $22.1 million and we contributed $20.6 million to DFSC as additional capital to facilitate the mergers. We use the equity method of accounting for our investment in DFSC. Under the equity method, we record our investment at cost, with adjustments for our share of DFSC s earnings and losses as well as changes in DFSC s equity due to unrealized gains and losses.

Basis of Consolidation

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

Use of Estimates

In preparing our consolidated financial statements, our management makes estimates and assumptions that affect the reported amounts of assets and liabilities at 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 consolidated financial statements. The most significant estimates relate to our insurance subsidiaries reserves for property and casualty insurance unpaid losses and loss expenses, valuation of investments and determination of other-than-temporary impairment and our insurance subsidiaries policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the estimates provided. We regularly review our methods for making these estimates as well as the continuing appropriateness of the estimated amounts, and we reflect any adjustment we consider necessary in our current results of operations.

Reclassification

We have reclassified certain amounts in 2011 as reported in our Consolidated Statements of Income to conform to the current year presentation.

Investments

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

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

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

Short-term investments 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. For equity securities, we write down the investment to its fair value and we reflect the amount of the write-down as a realized loss in our results of operations when we consider the decline in value of an individual investment to be other than temporary. We individually monitor all of our investments for other-than-temporary declines in value. Generally, we assume there has been an other-than-temporary decline in value if an individual equity security has depreciated in value by more than 20% of original cost and has been in such an unrealized loss position for more than six months. Effective April 1,

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2009, we adopted new accounting guidance related to the accounting for and presentation of impairment losses on debt securities. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If we determine it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss has occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, company or geographic events that have negatively impacted the value of a security and rating agency downgrades.

We amortize premiums and discounts on debt securities over the life of the security as an adjustment to yield using the effective interest method. We compute realized investment gains and losses using the specific identification method.

We amortize premiums and discounts for mortgage-backed debt securities using anticipated prepayments.

We account for investments in affiliates using the equity method of accounting. Under the equity method, we record our investment at cost, with adjustments for our share of the affiliate s earnings and losses as well as changes in the affiliate s equity due to unrealized gains and losses.

Fair Values of Financial Instruments

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

Investments - We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if we sold the security in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for our fixed maturity and equity investments. We generally obtain one price per security. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements based predominantly on observable market inputs. The pricing services do not use broker quotes in determining the fair values of our investments. Our investment personnel review the estimates of fair value the pricing services provide to determine if the estimates obtained are representative of fair values based upon their general knowledge of the market, their research findings related to unusual fluctuations in value and their comparison of such values to execution prices for similar securities. Our investment personnel monitor the market and are familiar with current trading ranges for similar securities and pricing of specific investments. Our investment personnel review all pricing estimates that we receive from the pricing services against their expectations with respect to pricing based on fair market curves, security ratings, coupon rates, security type and recent trading activity. Our investment personnel review documentation with respect to the pricing services pricing methodology that they obtain periodically to determine if the primary pricing sources, market inputs and pricing frequency for various security types are reasonable. We refer to Note 6 - Fair Value Measurements for more information regarding our methods and assumptions in estimating fair values.

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

Premiums and Reinsurance Receivables and Payables - The carrying amounts reported in the balance sheet for these instruments related to premiums and paid losses and loss expenses approximate their fair values.

Subordinated Debentures - The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Revenue Recognition

Our insurance subsidiaries recognize insurance premiums as income over the terms of the policies they issue. Our insurance subsidiaries calculate unearned premiums on a daily pro-rata basis. We recorded an unearned premium liability for the fair value of the net unexpired portion of the insurance contracts we acquired in connection with our acquisition of MICO. We recognized this unearned premium liability as income over the terms of MICO s policies.

Policy Acquisition Costs

We defer our insurance subsidiaries policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs, reduced by ceding commissions, that vary with and relate directly to the production of business. We amortize these deferred policy acquisition costs over the period in which our insurance subsidiaries earn the premiums. The method we follow 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 we expect to incur as our insurance subsidiaries earn the premium. 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

We report property and equipment at depreciated cost that we compute 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. At the time of establishing its estimates, an insurer recognizes that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. Our insurance subsidiaries base their estimates of liabilities for losses and loss expenses on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding certain claims, and consequently, it often becomes necessary for our insurance subsidiaries to refine and adjust their estimates of liability. We reflect any adjustments to our insurance subsidiaries liabilities for losses and loss expenses in our operating results in the period in which our insurance subsidiaries record the changes in estimates.

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Our insurance subsidiaries establish these liabilities for the purpose of covering the ultimate costs of settling all losses, including investigation and litigation costs. Our insurance subsidiaries base the amount of their 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 their policyholder incurred. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses.

We recorded a liability for the fair value of the net loss and loss expense reserves we assumed in connection with our acquisition of MICO. We incorporated various factors in determining the fair value of these reserve estimates, including the guarantee against any deficiency in excess of $1.0 million discussed in Note 4-Business Combinations.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries external environment and, to a lesser extent, assumptions as to our insurance subsidiaries internal operations. For example, our insurance subsidiaries have experienced a decrease in claims frequency on workers compensation 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 workers compensation claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in

the recording of claims, payment and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectibility of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded.

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

Income Taxes

We currently file a consolidated federal income tax return.

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

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. We define this risk as the potential loss in fair 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 of our total investment portfolio that we invest in any one security.

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

Our insurance subsidiaries have reinsurance agreements with Donegal Mutual and with a number of other major unaffiliated authorized reinsurers.

Reinsurance Accounting and Reporting

Our insurance subsidiaries rely upon reinsurance agreements to limit their maximum net loss from large single risks or risks in concentrated areas and to increase their capacity to write insurance. Reinsurance does not relieve our insurance subsidiaries from liability to their respective policyholders. To the extent that a reinsurer cannot pay losses for which it is liable under the terms of a reinsurance agreement, our insurance subsidiaries retain continued liability for such losses. However, in an effort to reduce the risk of non-payment, our insurance subsidiaries require all of their reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition that, in the opinion of management, is equivalent to a company with an A.M. Best rating of A- or better. We refer to Note 11 - Reinsurance for more information regarding our reinsurance agreements.

Stock-Based Compensation

We measure all share-based payments to employees, including grants of stock options, using a fair-value-based method and record such expense in our results of operations. In determining the expense we record for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, we estimate the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The significant assumptions we utilize in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility.

We did not realize any tax benefits upon the exercise of stock options in 2011, 2010 or 2009.

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Earnings per Share

We calculate basic earnings per share by dividing net income by the weighted-average number of common shares outstanding for the period. 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.

We have two classes of common stock, which we refer to as Class A common stock and Class B common stock. Our Class A common stock is entitled to cash dividends that are at least 10% higher than those declared and paid on our Class B common stock. Accordingly, we use the two-class method for the computation of earnings per common share. The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage that reflects the dividend rights of each class.

Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the underlying fair value of acquired entities. When completing acquisitions, we seek to also identify separately identifiable intangible assets that we have acquired. We assess goodwill and intangible assets with an indefinite useful life for impairment annually. We also assess goodwill and other intangible assets for impairment upon the occurrence of certain events. In making our assessment, we consider a number of factors including operating results, business plans, economic projections, anticipated future cash flows and current market data. Inherent uncertainties exist with respect to these factors and to our judgment in applying them when we make our assessment. Impairment of goodwill and other intangible assets could result from changes in economic and operating conditions in future periods.

2 - Impact of New Accounting Standards

In January 2010, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) 2010-06, Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Accounting Standards Codification (ASC) subtopic 820-10 by requiring new, and clarifying existing, fair value disclosures. We have included in these footnotes the disclosures ASU 2010-06 requires.

In October 2010, the FASB issued updated guidance to address the diversity in practice for the accounting for costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost must relate directly to the successful acquisition of a new or renewal insurance contract to qualify for deferral. If application of this guidance would result in the capitalization of acquisition costs that a reporting entity had not previously capitalized, the entity may elect not to capitalize those costs. The updated guidance is effective for periods ending after December 15, 2011. We do not expect the adoption of this guidance to have a material impact on our financial position or results of operations.

In May 2011, the FASB issued new guidance that eliminates the concepts of in-use and in-exchange when measuring the fair value of all financial instruments. The new guidance requires entities to measure the fair value of a financial asset on a stand-alone basis and not as part of a group. The new guidance requires several new disclosures including the disclosure of all transfers between Level 1 and Level 2 of the fair value hierarchy and additional disclosures regarding Level 3 assets. The guidance is effective for interim and annual periods beginning on or after December 15, 2011. The new guidance is to be applied prospectively. The adoption of this new guidance in 2012 will not impact our financial position, results of operations or cash flows.

In June 2011, the FASB issued new guidance related to the presentation of other comprehensive income. The new guidance provides entities with an option to either replace the income statement with a statement of comprehensive income, which would display both the components of net income and comprehensive in a combined statement, or to present a separate statement of comprehensive income immediately following the income statement. The new guidance does not affect the components of other comprehensive income or the calculation of earnings per share. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The new guidance is to be applied retrospectively with early adoption permitted. The adoption of this new guidance in 2012 will not impact our financial position, results of operations or cash flows.

In September 2011, the FASB issued new guidance related to evaluating goodwill for impairment. The new guidance provides entities with the option to perform a qualitative assessment of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount before applying the quantitative two-step goodwill impairment test. If an entity concludes that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it would not be required to perform the quantitative two-step goodwill impairment test. Entities also have the option to bypass the

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assessment of qualitative factors for any reporting unit in any period and proceed directly to performing the first step of the quantitative two-step goodwill impairment test, as was required prior to the issuance of this new guidance. An entity may begin or resume performing the qualitative assessment in any subsequent period. The new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, with early adoption permitted. We adopted this new guidance in 2011. The adoption of this new guidance did not impact our financial position, results of operations or cash flows.

3 - Transactions with Affiliates

Our insurance subsidiaries conduct business and have various agreements with Donegal Mutual that we describe in the following subparagraphs:

a. Reinsurance Pooling and Other Reinsurance Arrangements

Atlantic States, our largest subsidiary, and Donegal Mutual have a pooling agreement under which both companies contribute all of their direct written business to the pool and receive an allocated percentage of their combined underwriting results, excluding certain reinsurance Donegal Mutual assumes from our insurance subsidiaries. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States share of the pooled business to 80%. The intent of the pooling agreement is 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 between 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 reinsurance Atlantic States ceded to the pool during 2011, 2010 and 2009:

	2011	2010	2009
Premiums earned	$ 118,812,725	$ 105,376,068	$ 96,502,445
Losses and loss expenses	97,130,846	81,203,625	68,248,082
Prepaid reinsurance premiums	64,214,378	57,783,435	52,199,831
Liability for losses and loss expenses	77,312,645	65,028,781	55,396,390

The following amounts represent reinsurance Atlantic States assumed from the pool during 2011, 2010 and 2009:

	2011	2010	2009
Premiums earned	$ 266,687,610	$ 238,308,846	$ 223,223,583
Losses and loss expenses	206,907,170	160,256,348	138,058,878
Unearned premiums	141,880,039	125,322,884	117,044,000
Liability for losses and loss expenses	156,941,512	134,580,026	131,247,578

Donegal Mutual and Southern have a quota-share reinsurance agreement whereby Southern assumes 100% of the premiums and losses related to personal lines products Donegal Mutual offers in Virginia through the use of its automated policy quoting and issuance system. Donegal Mutual and Le Mars have a quota-share reinsurance agreement whereby Le Mars assumes 100% of the premiums and losses related to certain products Donegal Mutual offers in certain Midwest states, which provide the availability of complementary products to Le Mars commercial accounts. The following amounts represent reinsurance Southern and Le Mars assumed from Donegal Mutual pursuant to the quota-share reinsurance agreements during 2011, 2010 and 2009:

	2011	2010	2009
Premiums earned	$ 17,757,409	$ 14,516,901	$ 12,856,983
Losses and loss expenses	14,983,405	12,600,094	10,987,391
Unearned premiums	10,225,922	8,124,069	6,998,285
Liability for losses and loss expenses	7,770,053	7,316,879	4,868,486

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Donegal Mutual and MICO have a quota-share reinsurance agreement whereby Donegal Mutual assumes 25% of the premiums and losses related to the business of MICO. Donegal Mutual and Peninsula have a quota-share reinsurance agreement whereby Donegal Mutual assumes 100% of the premiums and losses related to the workers compensation product line of Peninsula in certain states. The business Donegal Mutual assumes becomes part of the pooling agreement between Donegal Mutual and Atlantic States.

The following amounts represent reinsurance ceded to Donegal Mutual pursuant to these quota-share reinsurance agreements during 2011, 2010 and 2009:

	2011	2010	2009
Premiums earned	$ 22,123,229	$ 4,516,313	$ 2,515,075
Losses and loss expenses	16,038,590	3,463,112	2,342,895
Prepaid reinsurance premiums	14,181,338	4,590,424	1,855,076
Liability for losses and loss expenses	11,868,641	4,006,231	1,980,626

Atlantic States, Southern and Le Mars each have a catastrophe reinsurance agreement with Donegal Mutual that provides coverage under any one catastrophic occurrence above a set retention ($2,000,000, $1,500,000 and $500,000 for Atlantic States, Southern and Le Mars, respectively) up to $5,000,000, with a combined retention of $3,000,000 for a catastrophe involving a combination of these subsidiaries. Our insurance subsidiaries recover losses in excess of $5,000,000 for any one catastrophe occurrence under catastrophe reinsurance agreements with unaffiliated reinsurers. Donegal Mutual and Southern have an excess of loss reinsurance agreement in which Donegal Mutual assumes up to $350,000 of losses in excess of $400,000. In 2009, Donegal Mutual and Sheboygan had an excess of loss reinsurance agreement in which Donegal Mutual assumed up to $50,000 of losses in excess of $150,000.

The following amounts represent reinsurance that our insurance subsidiaries ceded to Donegal Mutual pursuant to these reinsurance agreements during 2011, 2010 and 2009:

	2011	2010	2009
Premiums earned	$ 12,953,452	$ 8,110,268	$ 8,315,347
Losses and loss expenses	20,770,637	6,649,775	9,742,303
Liability for losses and loss expenses	3,980,024	3,441,447	3,268,129

The following amounts represent the effect of affiliated reinsurance transactions on net premiums our insurance subsidiaries earned during 2011, 2010 and 2009:

	2011	2010	2009
Assumed	$ 284,445,019	$ 252,825,747	$ 236,080,566
Ceded	(153,889,406)	(118,002,649)	(107,332,867)
Net	$ 130,555,613	$ 134,823,098	$ 128,747,699

The following amounts represent the effect of affiliated reinsurance transactions on net losses and loss expenses our insurance subsidiaries incurred during 2011, 2010 and 2009:

	2011	2010	2009
Assumed	$ 221,890,575	$ 172,856,442	$ 149,046,269
Ceded	(133,940,073)	(91,316,512)	(80,333,280)
Net	$ 87,950,502	$ 81,539,930	$ 68,712,989

b. Expense Sharing

Donegal Mutual provides facilities, management and other services to us and our insurance subsidiaries. Donegal Mutual allocates certain related expenses to Atlantic States in relation to the relative participation of Atlantic States and Donegal Mutual in the pooling agreement. Our insurance subsidiaries other than Atlantic States reimburse Donegal Mutual for their personnel costs and bear their proportionate share of information services costs based on their percentage of the total written premiums of the Donegal Insurance Group. Charges for these services totalled $64,711,860, $63,982,793 and $60,175,789 for 2011, 2010 and 2009, respectively.

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c. Lease Agreement

We lease office equipment and automobiles with terms ranging from 3 to 10 years to Donegal Mutual under a 10-year lease agreement dated January 1, 2011.

d. Legal Services

Donald H. Nikolaus, our President and one of our directors, is 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 of Pennsylvania. We pay such firm its customary fees for such services.

e. Union Community Bank

At December 31, 2011 and 2010, we had $10,907,454 and $11,851,757, respectively, in checking accounts with UCB, a wholly owned subsidiary of DFSC. We earned $1,019, $1,575 and $3,260 in interest on these accounts during 2011, 2010 and 2009, respectively.

4 - Business Combinations

On December 1, 2010, we acquired all of the outstanding stock of MICO. We accounted for this acquisition as a business combination.

We acquired MICO from West Bend and its other stockholders for a price equal to 122% of MICO s stockholders equity at November 30, 2010, or approximately $42.3 million in cash. We paid $35.1 million to MICO s stockholders in December 2010 and recorded an additional amount payable at December 31, 2010 of $7.2 million, which we paid pursuant to the terms of our acquisition agreement in the first quarter of 2011. The acquisition of MICO enabled us to extend our insurance business to the state of Michigan. MICO writes various lines of property and casualty insurance and had direct written premiums of $105.4 million and $106.6 million and net premiums earned of $26.9 million and $27.0 million for the years ended December 31, 2010 and 2009, respectively. MICO s stockholders equity and total assets at December 31, 2009 were $32.0 million and $224.5 million, respectively. We recorded goodwill of approximately $4.7 million and other intangible assets of approximately $958,000, none of which are deductible for federal income tax purposes. Pursuant to the terms of our acquisition agreement with West Bend, West Bend has guaranteed us against any deficiency in excess of $1.0 million in the loss and loss expenses of MICO at November 30, 2010. Conversely, we have agreed to return 50% of any redundancy in excess of $1.0 million. Any such deficiency or redundancy will be based on a final actuarial review of the development of such reserves to be conducted three years after November 30, 2010. Through December 1, 2010, MICO and West Bend were parties to quota-share reinsurance agreements whereby MICO ceded 75% (80% prior to 2008) of its business to West Bend. MICO and West Bend agreed to terminate the reinsurance agreement in effect at November 30, 2010 on a run-off basis. West Bend s obligations related to all past reinsurance agreements with MICO remain in effect for all policies effective prior to December 1, 2010. West Bend and MICO entered into a trust agreement on December 1, 2010. Under the terms of the trust agreement, for the sole benefit of MICO, West Bend placed into trust assets with a fair value equal to the amount of unearned premiums and unpaid losses and loss adjustment expenses, reduced by any net premium balances not yet paid by MICO, that West Bend had assumed pursuant to such reinsurance agreements at November 30, 2010. The amount of assets required to be held in trust is adjustable monthly based upon the remaining net obligations of West Bend. West Bend may terminate the trust agreement on the earlier of December 1, 2020 or the date when the obligations of West Bend are equal to or less than $5.0 million. At December 31, 2011, West Bend s net obligations under the reinsurance agreements were approximately $37.9 million, and the fair value of assets held in trust was approximately $43.0 million.

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We recorded the MICO assets that we acquired and the MICO liabilities that we assumed at their estimated acquisition date fair value. The following table summarizes the estimated fair value of the net assets we acquired at the date of the MICO acquisition based on purchase price allocations:

(in thousands)	
Assets acquired:	
Investments	$ 68,693
Premiums receivable	27,803
Prepaid reinsurance premiums	25,054
Reinsurance receivable	83,818
Goodwill	4,703
Other intangible assets	958
Other	2,801
Total assets acquired	213,830
Liabilities assumed:	
Losses and loss expenses	104,815
Unearned premiums	33,688
Reinsurance balances payable	16,899
Accrued expenses	9,990
Other	6,142
Total liabilities assumed	171,534
Net assets acquired	$ 42,296

We recorded goodwill of $4.7 million in connection with the MICO acquisition. The goodwill consists largely of economies of scale we expect to realize from integrating the operations of MICO with the operations of the Donegal Insurance Group and benefits we expect to derive from MICO s relationships with its independent agents and policyholders. We have evaluated the goodwill for impairment during 2011. We will evaluate the goodwill for impairment annually or upon the occurrence of certain future events.

We intend to operate MICO as a subsidiary and continue to maintain its trade name for the foreseeable future. We have therefore established a trade name intangible asset in the amount of $958,000, which represents the estimated value of the future benefits we will derive from the continued use of the trade name. We will not amortize the trade name intangible asset because we have determined that the trade name intangible asset has an indefinite life. We have evaluated the trade name intangible asset for impairment during 2011. We will evaluate the trade name intangible asset for impairment annually or upon the occurrence of certain future events.

Our consolidated financial statements for the year ended December 31, 2010 include the operations of MICO from December 1, 2010, the date we acquired it. Effective on December 1, 2010, MICO entered into a 50% quota-share reinsurance agreement with third-party reinsurers and a 25% quota-share reinsurance agreement with Donegal Mutual to replace the 75% quota-share reinsurance agreement MICO maintained with West Bend through November 30, 2010. Donegal Mutual includes the business it assumes from MICO in its pooling agreement with Atlantic States. Our total revenues related to the operations of MICO and Atlantic States allocation with respect to Donegal Mutual s quota-share reinsurance agreement for the period December 1, 2010 through December 31, 2010 were approximately $2.4 million. MICO s results of operations for the period December 1, 2010 through December 31, 2010 did not significantly impact our consolidated net income for 2010.

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The following table presents our unaudited pro forma historical results for the years ended December 31, 2010 and 2009 as if we had acquired MICO at January 1, 2009 and MICO had entered into a 25% quota-share reinsurance agreement with Donegal Mutual on that date:

	Year Ended December 31,	
	2010	2009
	(in thousands, except per share data)	
Total revenues	$ 458,231	$ 423,184
Income before income tax benefit	13,619	15,232
Income tax benefit	(741)	(146)
Net income	14,360	15,378
Class A earnings per share - basic and diluted	0.58	0.62
Class B earnings per share - basic and diluted	0.52	0.55

Significant pro forma income statement adjustments for the year ended December 31, 2009 included a $3.8 million decrease in premiums earned related to the recognition of the pro forma fair value adjustment associated with the net unearned premium liability at January 1, 2009. We have prepared the unaudited pro forma results above for comparative purposes only. These unaudited pro forma results are not necessarily indicative of the results of operations that actually would have resulted had the acquisition occurred at January 1, 2009, nor are the pro forma results necessarily indicative of future operating results.

5 - Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2011 and 2010 are as follows:

	2011			
Held to Maturity	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 1,000,000	$ 53,990	$	$ 1,053,990
Obligations of states and political subdivisions	56,965,959	2,857,005		59,822,964
Corporate securities	249,850	2,756		252,606
Residential mortgage-backed securities	273,810	18,986	9	292,787
Totals	$ 58,489,619	$ 2,932,737	$ 9	$ 61,422,347

	2011			
Available for Sale	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 59,431,789	$ 1,545,768	$	$ 60,977,557
Obligations of states and political subdivisions	372,663,210	26,252,161	38,789	398,876,582
Corporate securities	62,836,703	1,805,109	528,163	64,113,649
Residential mortgage-backed securities	119,367,152	3,306,932	43,694	122,630,390
Fixed maturities	614,298,854	32,909,970	610,646	646,598,178
Equity securities	7,238,803	606,440	407,705	7,437,538
Totals	$ 621,537,657	$ 33,516,410	$ 1,018,351	$ 654,035,716

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	2010			
Held to Maturity	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 1,000,000	$ 84,320	$	$ 1,084,320
Obligations of states and political subdivisions	59,852,427	2,893,921		62,746,348
Corporate securities	3,246,980	25,027		3,272,007
Residential mortgage-backed securities	667,022	39,042	18	706,046
Totals	$ 64,766,429	$ 3,042,310	$ 18	$ 67,808,721

	2010			
Available for Sale	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 57,283,889	$ 484,282	$ 452,352	$ 57,315,819
Obligations of states and political subdivisions	388,091,036	6,838,193	5,300,094	389,629,135
Corporate securities	67,518,441	649,969	1,073,486	67,094,924
Residential mortgage-backed securities	88,409,620	1,850,670	453,967	89,806,323
Fixed maturities	601,302,986	9,823,114	7,279,899	603,846,201
Equity securities	2,503,565	7,693,231	35,182	10,161,614
Totals	$ 603,806,551	$ 17,516,345	$ 7,315,081	$ 614,007,815

At December 31, 2011, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of $372.2 million and an amortized cost of $348.4 million. Our holdings also included special revenue bonds with an aggregate fair value of $86.5 million and an amortized cost of $81.0 million. With respect to both categories, we held no securities of any issuer that comprised more than 10% of the category at December 31, 2011. Education bonds and water and sewer utility bonds represented 59% and 17%, respectively, of our total investments in special revenue bonds based on their carrying values at December 31, 2011. Many of the issuers of the special revenue bonds we held at December 31, 2011 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held were similar to general obligation bonds.

At December 31, 2010, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of $366.7 million and an amortized cost of $362.5 million. Our holdings also included special revenue bonds with an aggregate fair value of $85.7 million and an amortized cost of $85.5 million. With respect to both categories, we held no securities of any issuer that comprised more than 10% of the category at December 31, 2010. Education bonds and water and sewer utility bonds represented 53% and 11%, respectively, of our total investments in special revenue bonds based on their carrying values at December 31, 2010. Many of the issuers of the special revenue bonds we held at December 31, 2010 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held were similar to general obligation bonds.

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We set forth below the amortized cost and estimated fair value of fixed maturities at December 31, 2011 by contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
Held to maturity		
Due in one year or less	$ 749,850	$ 753,246
Due after one year through five years	33,359,535	34,879,334
Due after five years through ten years	24,106,424	25,496,980
Due after ten years		
Residential mortgage-backed securities	273,810	292,787
Total held to maturity	$ 58,489,619	$ 61,422,347
Available for sale		
Due in one year or less	$ 15,265,671	$ 15,431,492
Due after one year through five years	64,964,688	66,372,443
Due after five years through ten years	155,488,232	164,416,999
Due after ten years	259,213,111	277,746,854
Residential mortgage-backed securities	119,367,152	122,630,390
Total available for sale	$ 614,298,854	$ 646,598,178

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2011 and 2010 amounted to $10,629,319 and $10,181,518, respectively.

Investments in affiliates consisted of the following at December 31, 2011 and 2010:

	2011	2010
DFSC	$ 31,857,246	$ 8,526,577
Other	465,000	465,000
Total	$ 32,322,246	$ 8,991,577

We account for investments in our affiliates using the equity method of accounting. Under this method, we record our investment at cost, with adjustments for our share of our affiliates earnings and losses as well as changes in our affiliates equity due to unrealized gains and losses. Our investments in affiliates include our 48.2% ownership interest in DFSC. In May 2011, DFSC merged with UNNF, with DFSC as the surviving company in the merger. Under the merger agreement, Province Bank FSB, which DFSC owned, and Union National Community Bank, which UNNF owned, also merged and began doing business as UCB. Donegal Mutual contributed $22.1 million and we contributed $20.6 million to DFSC as additional capital to facilitate the mergers. We, Donegal Mutual and DFSC have entered into a capital maintenance agreement with UCB, whereby we, Donegal Mutual and DFSC have agreed to make such capital contributions to UCB in the combined aggregate maximum amount that would not exceed $20.0 million as may be necessary from time to time to ensure that UCB has sufficient capital as demonstrated by UCB s maintenance of certain capital ratios. At December 31, 2011, UCB had capital ratios substantially above the minimum requirements under the capital maintenance agreement.

We include our share of DFSC s net income in our results of operations. We have compiled the following summary financial information for DFSC at December 31, 2011 and 2010 from the financial statements of DFSC.

	December 31,	
	2011	**2010**
Balance sheets:		
Total assets	$ 532,938,460	$ 99,118,459
Total liabilities	$ 466,940,425	$ 81,510,324
Stockholders equity	65,998,035	17,608,135
Total liabilities and stockholders equity	$ 532,938,460	$ 99,118,459

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	Year Ended December 31,		
	2011	**2010**	**2009**
Income statements:			
Net income (loss)	$ 4,196,054	$ (556,528)	$ 1,001,118

Other comprehensive income (loss) in our statements of comprehensive income includes net unrealized gains (losses) of $479,401, ($32,129) and $93,647 for 2011, 2010 and 2009, respectively, representing our share of DFSC s unrealized investment gains or losses.

Other investment in affiliates represents our investment in statutory trusts that hold our subordinated debentures that we discuss in Note 10 - Borrowings.

We derive net investment income, consisting primarily of interest and dividends, from the following sources:

	2011	**2010**	**2009**
Fixed maturities	$ 25,044,316	$ 23,995,220	$ 24,458,118
Equity securities	162,934	42,869	69,287
Short-term investments	57,296	91,665	199,735
Other	48,588	46,095	47,514
Investment income	25,313,134	24,175,849	24,774,654
Investment expenses	(4,454,955)	(4,226,135)	(4,144,071)
Net investment income	$ 20,858,179	$ 19,949,714	$ 20,630,583

We present below gross realized gains and losses from investments and the change in the difference between fair value and cost of investments:

	2011	**2010**	**2009**
Gross realized gains:			
Fixed maturities	$ 4,959,707	$ 4,136,455	$ 2,654,648
Equity securities	8,760,511	1,791,585	2,179,331
	13,720,218	5,928,040	4,833,979
Gross realized losses:			
Fixed maturities	163,316	533,918	102,143
Equity securities	1,275,635	998,402	252,278
	1,438,951	1,532,320	354,421
Net realized gains	$ 12,281,267	$ 4,395,720	$ 4,479,558
Change in difference between fair value and cost of investments:			
Fixed maturities	$ 29,646,545	$ (11,571,194)	$ 18,779,926
Equity securities	(7,459,314)	1,547,487	3,154,823
Totals	$ 22,187,231	$ (10,023,707)	$ 21,934,749

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We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2011 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	$	$	$	$
Obligations of states and political subdivisions	1,638,135	17,390	540,062	21,400
Corporate securities	10,101,753	528,164		
Residential mortgage-backed securities	7,411,682	43,692	626	9
Equity securities	4,083,863	407,705		
Totals	$ 23,235,433	$ 996,951	$ 540,688	$ 21,409

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2010 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	$ 23,901,400	$ 452,352	$	$
Obligations of states and political subdivisions	171,609,617	5,208,910	1,406,325	91,184
Corporate securities	44,101,089	1,061,972	490,970	11,514
Residential mortgage-backed securities	35,930,054	453,967	750	18
Equity securities	313,888	35,182		
Totals	$ 275,856,048	$ 7,212,383	$ 1,898,045	$ 102,716

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, we write down the investment to its fair value, and we reflect the amount of the write-down as a realized loss in our results of operations when we consider the decline in value of an individual investment to be other than temporary. We individually monitor all investments for other-than-temporary declines in value. Generally, we assume there has been an other-than-temporary decline in value if an individual equity security has depreciated in value by more than 20% of original cost and has been in such an unrealized loss position for more than six months. We held 12 equity securities that were in an unrealized loss position at December 31, 2011. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we considered these declines in value to be temporary. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the debt security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If we determine it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss has occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, company or geographic events that have negatively impacted the value of a security and rating agency downgrades. We held 21 debt securities that were in an unrealized loss position at December 31, 2011. Based upon our analysis of general market conditions and underlying factors impacting these debt securities, we considered these declines in value to be temporary.

We did not recognize any impairment losses in 2011, 2010 or 2009. We had no sales or transfers from the held to maturity portfolio in 2011, 2010 or 2009. We have no derivative instruments or hedging activities.

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6 - Fair Value Measurements

We account for financial assets using a framework that establishes a hierarchy that ranks the quality and reliability of inputs, or assumptions, used in the determination of fair value and we classify financial assets and liabilities carried at fair value in one of the following three categories:

Level 1 - quoted prices in active markets for identical assets and liabilities;

Level 2 - directly or indirectly observable inputs other than Level 1 quoted prices; and

Level 3 - unobservable inputs not corroborated by market data.

For investments that have quoted market prices in active markets, we use the quoted market price as fair value and include these investments in Level 1 of the fair value hierarchy. We classify publicly traded equity securities as Level 1. When quoted market prices in active markets are not available, we base fair values on quoted market prices of comparable instruments or price estimates we obtain from independent pricing services through a bank trustee. We classify our fixed maturity investments as Level 2. Our fixed maturity investments consist of U.S. Treasury securities and obligations of U.S. government corporations and agencies, obligations of states and political subdivisions, corporate securities and residential mortgage-backed securities.

We reclassified one equity security to Level 3 during 2009. We utilized a fair value model that incorporated significant other unobservable inputs, such as estimated volatility, to estimate the equity security s fair value. We were restricted from selling certain shares we obtained in the initial public offering for a period of 18 to 24 months, and the fair value we determined at December 31, 2010 reflected this selling restriction. During 2011, the restriction period expired for our holdings and we transferred the equity security from Level 3 to Level 1.

We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if we sold the security in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values or obtain market quotations for substantially all of our fixed maturity and equity investments. We generally obtain one price per security. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements based predominantly on observable market inputs. The pricing services do not use broker quotes in determining the fair values of our investments. Our investment personnel review the estimates of fair value the pricing services provide to determine if the estimates obtained are representative of fair values based upon their general knowledge of the market, their research findings related to unusual fluctuations in value and their comparison of such values to execution prices for similar securities. Our investment personnel monitor the market and are familiar with current trading ranges for similar securities and pricing of specific investments. Our investment personnel review all pricing estimates that we receive from the pricing services against their expectations with respect to pricing based on fair market curves, security ratings, coupon rates, security type and recent trading activity. Our investment personnel review documentation with respect to the pricing services pricing methodology that they obtain periodically to determine if the primary pricing sources, market inputs and pricing frequency for various security types are reasonable. At December 31, 2011 and 2010, we received one estimate per security from one of the pricing services, and we priced all but an insignificant amount of our Level 1 and Level 2 investments using those prices. In our review of the estimates provided by the pricing services at December 31, 2011 and 2010, we did not identify any discrepancies, and we did not make any adjustments to the estimates the pricing services provided.

We present our cash and short-term investments at estimated fair value. The carrying values in the balance sheet for premiums receivable and reinsurance receivables and payables for premiums and paid losses and loss expenses approximate their fair values. The carrying amounts reported in the balance sheet for our borrowings under our line of credit and our subordinated debentures approximate their fair values.

We evaluate our assets and liabilities on a regular basis to determine the appropriate level at which to classify them for each reporting period. Based on our review of the methodology and summary of inputs used by the pricing services, we have concluded that our Level 1 and Level 2 investments were classified properly at December 31, 2011 and 2010.

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The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities at December 31, 2011:

		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 60,977,557	$	$ 60,977,557	$
Obligations of states and political subdivisions	398,876,582		398,876,582	
Corporate securities	64,113,649		64,113,649	
Residential mortgage-backed securities	122,630,390		122,630,390	
Equity securities	7,437,538	6,178,136	1,259,402	
Totals	$ 654,035,716	$ 6,178,136	$ 647,857,580	$

The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities at December 31, 2010:

		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 57,315,820	$	$ 57,315,820	$
Obligations of states and political subdivisions	389,629,135		389,629,135	
Corporate securities	67,094,923		67,094,923	
Residential mortgage-backed securities	89,806,323		89,806,323	
Equity securities	10,161,614	1,152,250	1,436,476	7,572,888
Totals	$ 614,007,815	$ 1,152,250	$ 605,282,677	$ 7,572,888

The following table presents a roll forward of the significant unobservable inputs for our Level 3 equity securities for 2011 and 2010:

	2011	2010
Balance, January 1	$ 7,572,888	$ 6,231,654
Reclassification to Level 1	(8,175,000)	
Change in net unrealized gains	602,112	1,341,234
Balance, December 31	$	$ 7,572,888

7 - Deferred Policy Acquisition Costs

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

	2011	2010	2009
Balance, January 1	$ 34,445,579	$ 32,844,179	$ 29,541,281
Acquisition costs deferred	70,550,376	67,955,400	63,594,898
Amortization charged to earnings	(68,571,000)	(66,354,000)	(60,292,000)
Balance, December 31	$ 36,424,955	$ 34,445,579	$ 32,844,179

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8 - Property and Equipment

Property and equipment at December 31, 2011 and 2010 consisted of the following:

	2011	2010	Estimated Useful Life
Office equipment	$ 8,347,493	$ 8,324,930	5-15 years
Automobiles	2,111,218	1,966,152	3 years
Real estate	5,016,722	5,016,722	15-50 years
Software	2,316,617	2,518,826	5 years
	17,792,050	17,826,630	
Accumulated depreciation	(11,637,667)	(10,757,544)	
	$ 6,154,383	$ 7,069,086	

Depreciation expense for 2011, 2010 and 2009 amounted to $1.0 million, $1.2 million and $1.0 million, respectively.

9 - Liability for Losses and Loss Expenses

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

We summarize activity in our insurance subsidiaries liability for losses and loss expenses as follows:

	2011	2010	2009
Balance at January 1	$ 383,318,672	$ 263,598,844	$ 239,809,276
Less reinsurance recoverable	(165,422,373)	(83,336,726)	(78,502,518)
Net balance at January 1	217,896,299	180,262,118	161,306,758
Acquisition of MICO		26,960,063	
Incurred related to:			
Current year	340,671,237	277,193,930	241,012,436
Prior years	(168,460)	(2,885,072)	9,822,960
Total incurred	340,502,777	274,308,858	250,835,396
Paid related to:			
Current year	219,183,102	179,069,304	152,292,967
Prior years	96,201,195	84,565,436	79,587,069
Total paid	315,384,297	263,634,740	231,880,036

Net balance at December 31	243,014,779	217,896,299	180,262,118
Plus reinsurance recoverable	199,392,836	165,422,373	83,336,726
Balance at December 31	$ 442,407,615	$ 383,318,672	$ 263,598,844

Our insurance subsidiaries recognized a (decrease) increase in their liability for losses and loss expenses of prior years of ($168,460), ($2.9) million and $9.8 million in 2011, 2010 and 2009, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management personnel, and have made no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in these years. The 2011 development represented an immaterial percentage of the December 31, 2010 net carried reserves. The 2010 development represented 1.6% of the December 31, 2009 net carried reserves and resulted primarily from lower-than-expected severity in the private passenger automobile liability and homeowners lines of business in accident years prior to 2009. The 2009

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development represented 6.0% of the December 31, 2008 net carried reserves and resulted primarily from higher-than-expected severity in the private passenger automobile liability, homeowners and workers compensation lines of business in accident year 2008.

10 - Borrowings

Line of Credit

In June 2011, we renewed our existing credit agreement with Manufacturers and Traders Trust Company (M&T) relating to a $60.0 million unsecured, revolving line of credit that expires in July 2014. We have the right to request a one-year extension of the credit agreement as of each anniversary date of the agreement. In December 2010 and March 2011, we borrowed $35.0 million and $3.5 million, respectively, in connection with our acquisition of MICO. In May 2011, we borrowed $19.0 million in connection with the merger of UNNF with and into DFSC. At December 31, 2011, we had $54.5 million in outstanding borrowings and had the ability to borrow an additional $5.5 million at an interest rate equal to M&T s current prime rate or the then current LIBOR rate plus between 1.75% and 2.25%, depending on our leverage ratio. The interest rate on our outstanding borrowings is adjustable quarterly. At December 31, 2011, the interest rate on our outstanding borrowings was 2.28%. We pay a fee of 0.2% per annum on the loan commitment amount regardless of usage. The credit agreement requires our compliance with certain covenants, which include maintaining minimum levels of our net worth, leverage ratio and statutory surplus and the A.M. Best ratings of our insurance subsidiaries. With the exception of a requirement that we maintain a minimum interest coverage ratio, we complied with all requirements of the credit agreement during the year ended December 31, 2011. M&T waived the minimum interest coverage ratio requirement at December 31, 2011. Assuming no material increase in the interest rate on our outstanding borrowings, we must achieve a minimum of approximately $4.5 million in earnings before interest and taxes for the first quarter of 2012 in order to comply with the minimum interest coverage ratio requirement as of March 31, 2012. Assuming no material increase in the interest rate on our outstanding borrowings, we must achieve a minimum of approximately $18.2 million in earnings before interest and taxes for the full year of 2012 in order to comply with the minimum interest coverage ratio requirement as of December 31, 2012.

MICO has an agreement with the Federal Home Loan Bank (FHLB) of Indianapolis. Through its membership, MICO issued debt to the FHLB of Indianapolis in exchange for cash advances in the amount of $617,371 at December 31, 2010. The interest rate on the advances is variable and was .50% at December 31, 2010. MICO repaid the advances during 2011. The table below presents the amount of FHLB of Indianapolis stock purchased, collateral pledged and assets related to MICO s agreement at December 31, 2011.

FHLB stock purchased and owned as part of the agreement	$ 125,000
Collateral pledged, at par (carrying value $3,139,987)	3,450,000
Borrowing capacity currently available	2,991,405

Subordinated Debentures

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. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2011, the interest rate on these debentures was 4.28% and was next subject to adjustment on January 29, 2012. At December 31, 2011 and 2010, our consolidated balance sheets included an investment in a statutory 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. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2011, the interest rate on these debentures was 4.36% and was next subject to adjustment on February 24, 2012. At December 31, 2011 and 2010, our consolidated balance sheets included an investment in a statutory trust of $155,000 and subordinated debentures of $5.2 million related to this transaction.

In January 2002, West Bend purchased a surplus note from MICO for $5.0 million to increase MICO s statutory surplus. On December 1, 2010, Donegal Mutual purchased the surplus note from West Bend at face value. The surplus note carries an interest rate of 5.00%, and any repayment of principal or interest requires prior insurance regulatory approval. Upon receipt of regulatory approval, MICO paid $250,000 in interest to Donegal Mutual during 2011.

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11 - Reinsurance

Unaffiliated Reinsurers

Our insurance subsidiaries and Donegal Mutual purchase certain third-party reinsurance on a combined basis. Le Mars, MICO, Peninsula and Sheboygan also have separate third-party reinsurance programs that provide certain coverage that is commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with the requirements of our insurance subsidiaries and Donegal Mutual, 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 from A.M. Best. The external reinsurance our insurance subsidiaries and Donegal Mutual purchase includes excess of loss reinsurance, under which their losses are automatically reinsured, through a series of contracts, over a set retention (generally $1.0 million for 2012 and $750,000 prior to 2012), and catastrophic reinsurance, under which they recover, through a series of contracts, 90% to 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (generally $5.0 million). Our insurance subsidiaries principal third party reinsurance agreement in 2011 was a multi-line per risk excess of loss treaty that provided 100% coverage up to $1.0 million for both property and liability losses over the set retention of $750,000. For property insurance, our insurance subsidiaries also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $5.0 million per loss. For liability insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $40.0 million per occurrence. For workers compensation insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to $10.0 million on any one life. Our insurance subsidiaries and Donegal Mutual had property catastrophe coverage through a series of layered treaties up to aggregate losses of $135.0 million for any single event. As many as 20 reinsurers provided coverage on any one treaty with no reinsurer taking more than 27.0% of any one treaty. The amount of coverage provided under each of these types of reinsurance depends upon the amount, nature, size and location of the risks being reinsured. Donegal Mutual and our insurance subsidiaries also purchased facultative reinsurance to cover exposures from losses that exceeded the limits provided by our respective treaty reinsurance.

Through December 1, 2010, MICO and West Bend were parties to quota-share reinsurance agreements whereby MICO ceded 75% of its business to West Bend. MICO and West Bend agreed to terminate the reinsurance agreement in effect at November 30, 2010 on a run-off basis. West Bend s obligations related to all past reinsurance agreements with MICO remain in effect for all policies effective prior to December 1, 2010 as we discuss in Note 4-Business Combinations.

The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers during 2011, 2010 and 2009:

	2011	2010	2009
Premiums written	$ 80,265,127	$ 24,357,938	$ 19,758,224
Premiums earned	88,297,408	26,551,687	19,870,265
Losses and loss expenses	82,836,893	19,764,441	6,796,388
Prepaid reinsurance premiums	28,054,302	26,991,912	1,985,821
Liability for losses and loss expenses	106,231,527	92,945,915	22,692,993

Total Reinsurance

The following amounts represent our total ceded reinsurance transactions with both affiliated and unaffiliated reinsurers during 2011, 2010 and 2009:

	2011	2010	2009
Premiums earned	$ 242,186,814	$ 144,554,336	$ 127,203,132
Losses and loss expenses	216,776,966	111,080,953	87,129,668
Prepaid reinsurance premiums	106,450,018	89,365,771	56,040,728
Liability for losses and loss expenses	199,392,836	165,442,373	83,336,726

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The following amounts represent the effect of reinsurance on premiums written for 2011, 2010 and 2009:

	2011	2010	2009
Direct	$ 397,810,566	$ 279,627,255	$ 250,989,795
Assumed	306,416,861	262,574,572	244,046,312
Ceded	(250,176,390)	(150,679,539)	(131,807,381)
Net premiums written	$ 454,051,037	$ 391,522,288	$ 363,228,726

The following amounts represent the effect of reinsurance on premiums earned for 2011, 2010 and 2009:

	2011	2010	2009
Direct	$ 385,737,801	$ 269,394,549	$ 246,074,766
Assumed	287,919,197	253,189,916	236,153,843
Ceded	(242,186,814)	(144,554,336)	(127,203,132)
Net premiums earned	$ 431,470,184	$ 378,030,129	$ 355,025,477

12 - Income Taxes

Our provision for income tax consists of the following:

	2011	2010	2009
Current	$ (1,269,775)	$ 757,400	$ 3,096,798
Deferred	(5,922,491)	(2,380,430)	(1,250,187)
Federal tax (benefit) provision	$ (7,192,266)	$ (1,623,030)	$ 1,846,611

Our effective tax rate is different from the amount computed at the statutory federal rate of 35% for 2011, 2010 and 2009. The reasons for such difference and the related tax effects are as follows:

	2011	2010	2009
(Loss) income before income taxes	$ (6,739,313)	$ 9,844,149	$ 20,676,689
Computed expected taxes	(2,358,760)	3,445,452	7,236,841
Tax-exempt interest	(6,038,463)	(6,183,795)	(6,237,961)
Dividends received deduction	(32,056)	(996)	(17,574)
Proration	905,326	923,071	934,428
Other, net	331,687	193,238	(69,123)
Federal income tax (benefit) provision	$ (7,192,266)	$ (1,623,030)	$ 1,846,611

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The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2011 and 2010 are as follows:

	2011	2010
Deferred tax assets:		
Unearned premium	$ 16,113,291	$ 14,826,320
Loss reserves	7,339,644	6,954,685
Net operating loss carryforward	4,473,462	
Net operating loss carryforward - Le Mars	2,191,532	2,497,122
Alternative minimum tax credit carryforward	4,294,879	4,010,345
Other	634,885	1,508,336
Total gross deferred assets	35,047,693	29,796,808
Less valuation allowance	(440,778)	(746,368)
Net deferred tax assets	34,606,915	29,050,440
Deferred tax liabilities:		
Deferred policy acquisition costs	12,750,631	13,204,370
Net unrealized gains	11,711,531	3,649,494
Other	225,033	208,407
Total gross deferred tax liabilities	24,687,195	17,062,271
Net deferred tax asset	$ 9,919,720	$ 11,988,169

We provide a valuation allowance when we believe it is more likely than not that we will not realize some portion of the tax asset. At December 31, 2011 and 2010, we established a valuation allowance of $440,778 and $746,368, respectively, related to a portion of the net operating loss carryforward of Le Mars that we acquired on January 1, 2004. We have determined that we are not required to establish a valuation allowance for the other net deferred tax assets of $34.6 million and $29.1 million at December 31, 2011 and 2010, respectively, since it is more likely than not that we will realize these deferred tax assets 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, 2011, we have a net operating loss carryforward of $12.8 million, which is available to offset our taxable income. This amount will expire in 2031 if not utilized. The net operating loss carryforward of $6.3 million from Le Mars will begin to expire in 2020 if not utilized and is subject to an annual limitation of approximately $376,000. We also have an alternative minimum tax credit carryforward of $4.3 million with an indefinite life.

13 - 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 declared a dividend of two shares of Class A common stock for each share of Class B common stock, after the one-for-three reverse split, held of record at the close of business April 19, 2001.

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 after payment of all of our obligations.

In February 2009, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 300,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of Securities and Exchange Commission Rule 10b-18 and in privately negotiated transactions. We purchased 119,257 and 9,702 shares of our Class A common stock under this program during 2011 and 2010, respectively. At December 31, 2011, we had the authority to purchase 163,372 shares under this program.

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At December 31, 2011, our treasury stock consisted of 781,558 and 72,465 shares of Class A common stock and Class B common stock, respectively. At December 31, 2010, our treasury stock consisted of 662,301 and 72,465 shares of Class A common stock and Class B common stock, respectively.

14 - Stock Compensation Plans

Equity Incentive Plans

During 1996, we adopted an Equity Incentive Plan for Employees. During 2001, we adopted a nearly identical plan that made a total of 2,666,667 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. During 2005, we amended the plan to make a total of 4,000,000 shares of Class A common stock available for issuance. During 2007, we adopted a nearly identical plan that made a total of 3,500,000 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. During 2011, we adopted a nearly identical plan that made a total of 3,500,000 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. Each plan provides for the granting of awards by our board of directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. The plans provide that stock options may become exercisable up to ten years from date of grant, with an option price not less than fair market value on date of grant. We have not granted any stock appreciation rights.

During 1996, we adopted an Equity Incentive Plan for Directors. During 2001, we adopted a nearly identical plan that made 355,556 shares of Class A common stock available for issuance to our directors and those of our subsidiaries and affiliates. During 2007, we adopted a nearly identical plan that made 400,000 shares of Class A common stock available for issuance to our directors and the directors of our subsidiaries and affiliates. During 2011, we adopted a nearly identical plan that made 400,000 shares of Class A common stock available for issuance to our directors and the directors of our subsidiaries and affiliates. We may make awards in the form of stock options. The plan also provides for the issuance of 400 shares of restricted stock to each director on the first business day of January in each year. At December 31, 2011, we had 521,500 unexercised options under these plans. In addition, we issued 5,598, 5,598 and 4,665 shares of restricted stock on January 2, 2011, 2010 and 2009, respectively.

We measure all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and record such expense in our results of operations. In determining the expense we record for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, we estimate the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The significant assumptions we utilize in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility. The risk-free interest rate is the implied yield currently available on U.S. Treasury zero coupon issues with a remaining term equal to the expected term used as the assumption in the model. We base the expected term of an option award on our historical experience of similar awards. We determine the dividend yield by dividing the per share dividend by the grant date stock price. We base the expected volatility on the volatility of our stock price over a historical period comparable to the expected term.

The weighted-average grant date fair value of options granted during 2011 was $1.90. We calculated this fair value based upon a risk-free interest rate of .75%, expected life of 5 years, expected volatility of 31% and expected dividend yield of 4%.

The weighted-average grant date fair value of options granted during 2010 was $1.26. We calculated this fair value based upon a risk-free interest rate of 1.04%, expected life of 3 years, expected volatility of 29% and expected dividend yield of 4%.

The weighted-average grant date fair value of options granted during 2009 was $1.63. We calculated this fair value based upon a risk-free interest rate of 1.50%, expected life of 3 years, expected volatility of 24% and expected dividend yield of 3%.

We charged compensation expense for our stock compensation plans against income before income taxes of $283,811, $46,733 and $232,872 for the years ended December 31, 2011, 2010 and 2009, respectively, with a corresponding income tax benefit of $96,496, $15,889 and $79,176. At December 31, 2011 and 2010, our total unrecognized compensation cost related to non-vested share-based compensation granted under the plan was $929,679 and $255,105, respectively. We expect to recognize this cost over a weighted average period of 7.6 years.

We account for share-based compensation to employees and directors of Donegal Mutual as share-based compensation to employees of a controlling entity. As such, we measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to options granted to the employees and directors of Donegal Mutual, the employer of record for the employees that provide services to us. We recorded implied dividends of $2,283,860, $1,309,734 and $62,991 for the years ended December 31, 2011, 2010 and 2009, respectively.

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We did not receive any cash from option exercises in 2011, 2010 or 2009. All options issued prior to 2001 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 2011.

Information regarding activity in our stock option plans follows:

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2008	3,422,432	$ 17.98
Granted - 2009	5,000	17.50
Forfeited - 2009	(137,333)	17.97
Outstanding at December 31, 2009	3,290,099	17.98
Granted - 2010	1,787,500	14.00
Forfeited - 2010	(15,500)	15.69
Expired - 2010	(1,063,432)	15.76
Outstanding at December 31, 2010	3,998,667	16.80
Granted - 2011	2,321,000	12.52
Forfeited - 2011	(52,000)	15.63
Expired - 2011	(958,667)	21.00
Outstanding at December 31, 2011	5,309,000	$ 14.18
Exercisable at:		
December 31, 2009	2,451,556	$ 17.74
December 31, 2010	1,805,751	$ 18.13
December 31, 2011	1,821,333	$ 16.42

Shares available for future option grants at December 31, 2011 total 1,585,000 shares under all plans.

The following table summarizes information about fixed stock options at December 31, 2011:

Exercise Price	Number of Options Outstanding	Weighted-Average Remaining Contractual Life	Number of Options Exercisable
$12.50	2,295,000	10.0 years	
14.00	1,776,000	4.0 years	585,333
15.00	3,000	4.0 years	1,000
17.50	1,211,500	1.5 years	1,211,500
18.70	3,000	1.5 years	3,000
21.00	20,500	1.0 year	20,500
Total	5,309,000		1,821,333

Employee Stock Purchase Plans

During 1996, we adopted an Employee Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance. During 2011, we adopted a nearly identical plan that made 300,000 shares of Class A common stock available for issuance

The 2011 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 each enrollment period (June 1 and December 1 of each year) under the plan or 85% of the fair market value of our common stock on the last day of each subscription period (June 30 and December 31 of each year).

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A summary of plan activity follows:

	Shares Issued	
	Price	Shares
January 1, 2009	$ 14.25	10,770
July 1, 2009	12.93	11,304
January 1, 2010	12.85	11,717
July 1, 2010	10.45	12,403
January 1, 2011	11.02	13,243
July 1, 2011	10.88	11,371

On January 1, 2012, we issued an additional 10,523 shares at a price of $11.91 per share under this plan.

Agency Stock Purchase Plans

During 1996, we adopted an Agency Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance. During 2011, we adopted a nearly identical plan that made 300,000 shares of Class A common stock available for issuance. The plan provides for agents of our insurance subsidiaries and Donegal Mutual to invest up to $12,000 per subscription period (April 1 to September 30 and October 1 to March 31 of each year) under various methods. We issue stock at the end of each subscription period at a price equal to 90% of the average market price during the last ten trading days of each subscription period. During 2011, 2010 and 2009, we issued 66,260, 56,879 and 48,427 shares, respectively, under this plan. Expense recognized under the plan was not material.

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15 - 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:

	2011	2010	2009
Atlantic States:			
Statutory capital and surplus	$ 173,505,872	$ 191,775,057	$ 189,679,919
Statutory unassigned surplus	113,497,280	131,817,978	133,732,099
Statutory net (loss) income	(7,729,040)	11,002,447	12,445,231
Southern:			
Statutory capital and surplus	60,876,093	63,609,630	64,519,825
Statutory unassigned surplus	9,364,037	12,612,044	15,402,239
Statutory net income (loss)	1,795,195	(2,083,206)	(1,017,998)
Le Mars:			
Statutory capital and surplus	24,720,327	25,539,580	28,288,730
Statutory unassigned surplus	11,373,158	12,485,531	15,277,563
Statutory net (loss) income	(1,661,327)	(3,166,242)	716,138
Peninsula:			
Statutory capital and surplus	40,744,215	41,932,367	38,986,329
Statutory unassigned surplus	22,601,043	23,580,784	20,832,470
Statutory net income	1,210,247	2,336,947	1,023,349
Sheboygan:			
Statutory capital and surplus	10,800,499	11,671,405	11,857,971
Statutory unassigned (deficit) surplus	(1,437,493)	(479,140)	(243,626)
Statutory net (loss) income	(1,237,478)	(286,613)	588,098
MICO:			
Statutory capital and surplus	39,264,423	37,343,663	33,942,137
Statutory unassigned surplus	12,689,880	10,240,870	6,689,663
Statutory net income	2,889,619	3,026,178	2,589,784

Our principal source of cash for payment of dividends are dividends from our insurance subsidiaries. State insurance laws require our insurance subsidiaries to maintain certain minimum capital and surplus on a statutory basis. Our insurance subsidiaries are subject to regulations that restrict payment of dividends from statutory surplus 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, 2011, our insurance subsidiaries had statutory capital and surplus substantially above the RBC requirements. Amounts available for distribution to us as dividends from our insurance subsidiaries without prior approval of insurance regulatory authorities in 2012 are $17,350,587 from Atlantic States, $1,795,195 from Southern, $2,472,033 from Le Mars, $4,074,422 from Peninsula, $0 from Sheboygan and $3,926,442 from MICO.

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16 - Reconciliation of Statutory Filings to Amounts Reported Herein

Our insurance subsidiaries must file financial statements with state insurance regulatory authorities using accounting principles and practices established by those authorities, which we refer to as statutory accounting principles (SAP). Accounting principles used to prepare these statutory financial statements differ from those used to prepare financial statements on the basis of generally accepted accounting principles.

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

	$(000,000,000)	$(000,000,000)	$(000,000,000)
		Year Ended December 31,	
	2011	**2010**	**2009**
Statutory net (loss) income of insurance subsidiaries	$ (4,732,784)	$ 9,163,680	$ 13,754,818
Increases (decreases):			
Deferred policy acquisition costs	1,979,376	1,601,400	3,302,898
Deferred federal income taxes	5,922,490	2,380,430	1,250,187
Salvage and subrogation recoverable	1,273,000	748,000	542,000
Amortization of MICO fair value adjustments	(3,275,777)	(597,643)	
Consolidating eliminations and adjustments	(15,080,164)	(12,178,977)	(13,521,106)
Parent-only net income	14,366,812	10,350,289	13,501,281
Net income as reported herein	$ 452,953	$ 11,467,179	$ 18,830,078

	$(000,000,000)	$(000,000,000)	$(000,000,000)
		Year Ended December 31,	
	2011	**2010**	**2009**
Statutory capital and surplus of insurance subsidiaries	$ 349,911,429	$ 371,871,702	$ 333,332,774
Increases (decreases):			
Deferred policy acquisition costs	36,424,955	34,445,579	32,844,179
Deferred federal income taxes	(21,007,223)	(14,834,855)	(15,676,995)
Salvage and subrogation recoverable	11,228,000	9,955,000	9,207,000
Non-admitted assets and other adjustments, net	1,478,988	4,889,231	2,913,878
Fixed maturities	33,165,065	4,430,879	13,135,848
Parent-only equity and other adjustments	(27,749,622)	(30,654,726)	9,749,015
Stockholders equity as reported herein	$ 383,451,592	$ 380,102,810	$ 385,505,699

17 - Supplementary Cash Flow Information

The following reflects net income taxes and interest paid during 2011, 2010 and 2009:

	$(000,000,000)	$(000,000,000)	$(000,000,000)
	2011	**2010**	**2009**
Income taxes	$ 324,291	$ 1,100,000	$ 1,307,418
Interest	1,793,366	705,210	1,828,278

During 2009, we paid interest and penalties in the amount of $974,204 related to a premium tax litigation settlement. We recorded this amount as interest expense in accordance with our accounting policy.

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18 - Earnings Per Share

We have two classes of common stock, which we refer to as Class A common stock and Class B common stock. Our Class A common stock is entitled to cash dividends that are at least 10% higher than the cash dividends declared and paid on our Class B common stock. Accordingly, we use the two-class method for the computation of earnings per common share. The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage reflecting the dividend rights of each class.

We present below a reconciliation of the numerators and denominators we used in the basic and diluted per share computations for our Class A common stock:

	Year Ended December 31,		
(dollars in thousands, except per share data)	2011	2010	2009
Basic earnings per share:			
Numerator:			
Allocation of net income	$ 390	$ 9,183	$ 15,049
Denominator:			
Weighted-average shares outstanding	19,997,146	19,961,274	19,903,069
Basic earnings per share	$ 0.02	$ 0.46	$ 0.76
Diluted earnings per share:			
Numerator:			
Allocation of net income	$ 390	$ 9,183	$ 15,049
Denominator:			
Number of shares used in basic computation	19,997,146	19,961,274	19,903,069
Weighted-average effect of dilutive securities			
Add: Director and employee stock options	36,499	17,794	
Number of shares used in per share computations	20,033,645	19,979,068	19,903,069
Diluted earnings per share	$ 0.02	$ 0.46	$ 0.76

We used the following information in the basic and diluted per share computations for our Class B common stock:

	Year Ended December 31,		
(dollars in thousands, except per share data)	2011	2010	2009
Basic and diluted earnings per share:			
Numerator:			
Allocation of net income	$ 63	$ 2,284	$ 3,781
Denominator:			
Weighted-average shares outstanding	5,576,775	5,576,775	5,576,775
Basic and diluted earnings per share	$ 0.01	$ 0.41	$ 0.68

During 2011, 2010 and 2009, we did not include certain options to purchase shares of common stock in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price. The following reflects such options that remained outstanding at December 31, 2011, 2010 and 2009:

	2011	2010	2009
Options excluded from diluted earnings per share	1,238,000	2,219,167	3,290,099

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19 - Condensed Financial Information of Parent Company

Condensed Balance Sheets

(in thousands)

December 31,	**2011**	**2010**
Assets		
Investment in subsidiaries/affiliates (equity method)	$ 445,795	$ 422,144
Short-term investments	9,258	15,695
Cash	684	841
Property and equipment	1,224	1,309
Other	381	1,078
Total assets	$ 457,342	$ 441,067
Liabilities and Stockholders Equity		
Liabilities		
Cash dividends declared to stockholders	$ 2,996	$ 2,871
Borrowings under line of credit	54,500	35,000
Subordinated debentures	15,465	15,465
Payable for the purchase of MICO		7,207
Other	930	421
Total liabilities	73,891	60,964
Stockholders equity	383,451	380,103
Total liabilities and stockholders equity	$ 457,342	$ 441,067

Condensed Statements of Income and Comprehensive Income

(in thousands)

Year Ended December 31,	**2011**	**2010**	**2009**
Statements of Income			
Revenues			
Dividends from subsidiaries	$ 16,000	$ 12,000	$ 14,000
Other	2,995	701	1,476
Total revenues	18,995	12,701	15,476
Expenses			
Operating expenses	2,392	2,060	1,490
Interest	1,864	778	773
Total expenses	4,256	2,838	2,263
Income before income tax expense (benefit) and equity in undistributed net income of subsidiaries	14,739	9,863	13,213
Income tax expense (benefit)	372	(487)	(288)

Income before (loss) equity in undistributed net income of subsidiaries	14,367	10,350	13,501
(Loss) equity in undistributed net income of subsidiaries	(13,914)	1,117	5,329
Net income	$ 453	$ 11,467	$ 18,830
Statements of Comprehensive Income			
Net income	$ 453	$ 11,467	$ 18,830
Other comprehensive income (loss), net of tax			
Unrealized gain (loss) - subsidiaries	14,972	(6,446)	13,293
Other comprehensive income (loss), net of tax	14,972	(6,446)	13,293
Comprehensive income	$ 15,425	$ 5,021	$ 32,123

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Condensed Statements of Cash Flows

(in thousands)

Year Ended December 31,	**2011**	**2010**	**2009**
Cash flows from operating activities:			
Net income	$ 453	$ 11,467	$ 18,830
Adjustments:			
Loss (equity) in undistributed net income of subsidiaries	13,914	(1,117)	(5,329)
Other	(396)	547	(669)
Net adjustments	13,518	(570)	(5,998)
Net cash provided	13,971	10,897	12,832
Cash flows from investing activities:			
Net sale (purchase) of short-term investments	6,437	(249)	(2,609)
Net purchase of property and equipment	(380)	(492)	(644)
Investment in subsidiaries	(27,777)	(35,088)	(100)
Other	43	20	19
Net cash used	(21,677)	(35,809)	(3,334)
Cash flows from financing activities:			
Cash dividends paid	(11,874)	(11,405)	(10,998)
Issuance of common stock	1,461	1,199	1,386
Payments on line of credit	(3,000)		
Borrowings under line of credit	22,500	35,000	
Repurchase of treasury stock	(1,538)	(146)	(393)
Net cash provided (used)	7,549	24,648	(10,005)
Net change in cash	(157)	(264)	(507)
Cash at beginning of year	841	1,105	1,612
Cash at end of year	$ 684	$ 841	$ 1,105

20 - Segment Information

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

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

We do not allocate assets to the personal and commercial lines and review the two segments in total for purposes of decision-making. We operate only in the United States and no single customer or agent provides 10 percent or more of our revenues.

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Financial data by segment is as follows:

	$(000,000) 2011	$(000,000) 2010 (in thousands)	$(000,000) 2009
Revenues:			
Premiums earned:			
Commercial lines	$ 152,247	$ 117,755	$ 113,233
Personal lines	282,498	260,900	242,313
SAP premiums earned	434,745	378,655	355,546
GAAP adjustments	(3,275)	(625)	(521)
GAAP premiums earned	431,470	378,030	355,025
Net investment income	20,858	19,950	20,631
Realized investment gains	12,281	4,396	4,480
Other	10,409	6,173	6,597
Total revenues	$ 475,018	$ 408,549	$ 386,733

	$(000,000) 2011	$(000,000) 2010 (in thousands)	$(000,000) 2009
Income before income taxes:			
Underwriting (loss) income:			
Commercial lines	$ (6,560)	$ 2,252	$ 5,805
Personal lines	(40,739)	(22,526)	(17,235)
SAP underwriting loss	(47,299)	(20,274)	(11,430)
GAAP adjustments	1,532	2,458	3,636
GAAP underwriting loss	(45,767)	(17,816)	(7,794)
Net investment income	20,858	19,950	20,631
Realized investment gains	12,281	4,396	4,480
Other	5,889	3,314	3,360
(Loss) income before income taxes	$ (6,739)	$ 9,844	$ 20,677

21 - Guaranty Fund and Other Insurance-Related Assessments

Our insurance subsidiaries liabilities for guaranty fund and other insurance-related assessments were $1,812,078 and $2,129,722 at December 31, 2011 and 2010, respectively. These liabilities included $548,644 and $440,553 related to surcharges collected by our insurance subsidiaries on behalf of regulatory authorities for 2011 and 2010, respectively.

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22 - Interim Financial Data (unaudited)

	2011			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Net premiums earned	$ 103,795,279	$ 104,991,401	$ 108,506,809	$ 114,176,695
Total revenues	111,583,442	117,054,498	119,164,471	127,215,208
Net losses and loss expenses	73,079,565	84,195,796	89,411,543	93,815,873
Net income (loss)	2,205,936	(1,693,989)	819,926	(878,920)
Net earnings (loss) per common share:				
Class A common stock - basic and diluted	0.09	(0.07)	0.03	(0.03)
Class B common stock - basic and diluted	0.08	(0.06)	0.03	(0.03)

	2010			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Net premiums earned	$ 91,372,096	$ 93,002,409	$ 94,948,843	$ 98,706,781
Total revenues	97,914,750	101,525,354	103,750,318	105,715,668
Net losses and loss expenses	67,981,486	68,509,616	67,401,697	70,416,059
Net income	234,758	1,739,728	4,909,879	4,582,814
Net earnings per common share:				
Class A common stock - basic and diluted	0.01	0.07	0.20	0.18
Class B common stock - basic and diluted	0.01	0.06	0.18	0.16

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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 (the Company) as of December 31, 2011 and 2010, 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, 2011. 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, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Oversight Board (United States), Donegal Group Inc. s internal control over financial reporting as of December 31, 2011 based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 12, 2012 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

Philadelphia, Pennsylvania

March 12, 2012

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.
None.

Item 9A. Controls and Procedures.
Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) at December 31, 2011 covered by this Form 10-K Report. Based on such evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, at December 31, 2011, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information we are required to disclose in the reports that we file or submit under the Exchange Act and our disclosure controls and procedures are also effective to ensure that information we disclose in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure.

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 Exchange Act. 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 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 at December 31, 2011.

The effectiveness of our internal control over financial reporting at December 31, 2011 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report which is included in this Form 10-K Annual Report.

Changes in Internal Control over Financial Reporting

We did not make any changes to our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth quarter of 2010 that have materially affected, or are reasonably likely to affect materially, our internal control over financial reporting.

Item 9B. Other Information.
None.

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Report of Independent Registered Public Accounting Firm

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

We have audited Donegal Group Inc. s (the Company) internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Donegal Group Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included 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, Donegal Group Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, 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, 2011 and 2010, 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, 2011, and our report dated March 12, 2012 expressed an unqualified opinion on those consolidated financial statements.

Philadelphia, Pennsylvania

March 12, 2012

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PART III

Item 10. Directors, Executive Officers and Corporate Governance of the Registrant.
We incorporate the response to this Item 10 by reference to our proxy statement we will file with the SEC on or about March 19, 2012 relating to our annual meeting of stockholders that we will hold on April 19, 2012, or our Proxy Statement. We respond to this Item with respect to our executive officers by reference to Part I of this Form 10-K Report.

We incorporate the full text of our Code of Business Conduct and Ethics by reference to Exhibit 14 to this Form 10-K Report.

Item 11. Executive Compensation.
We incorporate the response to this Item 11 by reference to our Proxy Statement. Neither the Report of our Compensation Committee nor the Report of our Audit Committee included in our Proxy Statement shall constitute or be deemed to constitute a filing with the SEC under the Securities Act or the Exchange Act or be deemed to have been incorporated by reference into any filing we make under the Securities Act or the Exchange Act, except to the extent we specifically incorporate the Report of Our Compensation Committee or the Report of Our Audit Company by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.
We incorporate the response to this Item 12 by reference to our Proxy Statement.

Item 13. Certain Relationships and Related Transactions and Director Independence.
We incorporate the response to this Item 13 by reference to our Proxy Statement.

Item 14. Principal Accountant Fees and Services.
We incorporate the response to this Item 14 by reference to our Proxy Statement.

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PART IV

Item 15. Exhibits and Financial Statement Schedule.

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

(a) Consolidated Financial Statements

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Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2011, 2010 and 2009	58
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Report and Consent of Independent Registered Public Accounting Firm	
(Filed as Exhibit 23)	

(b) Financial Statement Schedule

Schedule III Supplementary Insurance Information	99

We have omitted all other schedules since they are not required, not applicable or the information is included in the financial statements or notes to the financial statements.

(c) Exhibits

Exhibit No.	Description of Exhibits	Reference
3.1	Certificate of Incorporation of Donegal Group Inc., as amended.	(a)
3.2	Amended and Restated By-laws of Donegal Group Inc.	(i)
Management Contracts and Compensatory Plans or Arrangements		
10.1	Donegal Group Inc. 2011 Employee Stock Purchase Plan.	(c)
10.2	Donegal Group Inc. 2011 Equity Incentive Plan for Employees.	(c)
10.3	Donegal Group Inc. 2011 Equity Incentive Plan for Directors.	(c)

10.4	Employment Agreement dated as of July 29, 2011 among Donegal Mutual Insurance Company, Donegal Group Inc. and Donald H. Nikolaus.	(d)
10.5	Consulting Agreement dated as of July 29, 2011 among Donegal Mutual Insurance Company, Donegal Group Inc. and Donald H. Nikolaus.	(d)
10.6	Employment Agreement dated as of July 29, 2011 among Donegal Mutual Insurance Company, Donegal Group Inc. and Kevin G. Burke.	(d)
10.7	Employment Agreement dated as of July 29, 2011 among Donegal Mutual Insurance Company, Donegal Group Inc. and Cyril J. Greenya.	(d)
10.8	Employment Agreement dated as of July 29, 2011 among Donegal Mutual Insurance Company, Donegal Group Inc. and Jeffrey D. Miller.	(d)

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10.9	Employment Agreement dated as of July 29, 2011 among Donegal Mutual Insurance Company, Donegal Group Inc. and Robert G. Shenk.	(d)
10.10	Employment Agreement dated as of July 29, 2011 among Donegal Mutual Insurance Company, Donegal Group Inc. and Daniel J. Wagner.	(d)
10.11	Donegal Mutual Insurance Company 401(k) Plan.	(e)
10.12	Amendment No. 1 effective January 1, 2000 to Donegal Mutual Insurance Company 401(k) Plan.	(e)
10.13	Amendment No. 2 effective January 6, 2000 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
10.14	Amendment No. 3 effective July 23, 2001 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
10.15	Amendment No. 4 effective January 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
10.16	Amendment No. 5 effective December 31, 2001 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
10.17	Amendment No. 6 effective July 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan.	(h)
10.18	Donegal Group Inc. 2007 Equity Incentive Plan for Employees.	(j)
10.19	Donegal Group Inc. 2007 Equity Incentive Plan for Directors.	(j)
10.20	Donegal Group Inc. Incentive Compensation Program.	(k)
Other Material Contracts		
10.21	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia.	(f)
10.22	Surplus Note Purchase Agreement dated September 8, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	(l)
10.23	Quota-share Reinsurance Agreement dated October 30, 2009 but effective 11:59 p.m. on October 31, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	(l)

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10.24	Services and Affiliation Agreement dated October 30, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	(l)
10.25	Technology License Agreement dated October 30, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	(l)
10.26	Amended and Restated Proportional Reinsurance Agreement dated March 1, 2010 between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(l)
10.27	Agreement and Plan of Merger dated April 19, 2010, and as amended May 20, 2010, among Donegal Acquisition Inc., Donegal Financial Services Corporation, Donegal Group Inc. and Union National Financial Corporation; amended dated September 1, 2010; amended dated December 8, 2010.	(m)
10.28	Amended and Restated Agreement and Plan of Merger dated December 6, 2010 among Michigan Insurance Company, West Bend Mutual Insurance Company, Donegal Group Inc. and DGI Acquisition Corp.	(n)
10.29	Amended and Restated Tax Sharing Agreement dated December 1, 2010 among Donegal Group, Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company, Peninsula Indemnity Company and Michigan Insurance Company.	(o)
10.30	Amended and Restated Services Allocation Agreement dated December 1, 2010 among Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company, Peninsula Indemnity Company and Michigan Insurance Company.	(o)
10.31	Quota-share Reinsurance Agreement dated December 1, 2010 between Donegal Mutual Insurance Company and Michigan Insurance Company.	(o)
10.32	Donegal Group Inc. 2011 Agency Stock Purchase Plan.	(p)
10.33	Credit Agreement dated June 21, 2010 between Donegal Group Inc. and Manufacturers and Traders Trust Company, First Amendment to Credit Agreement dated October 12, 2010 and Second Amendment to Credit Agreement dated June 1, 2011.	Filed herewith
14	Code of Business Conduct and Ethics	(g)

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21	Subsidiaries of Registrant.	Filed herewith
23	Report and Consent of Independent Registered Public Accounting Firm.	Filed herewith
31.1	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer.	Filed herewith
31.2	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Financial Officer.	Filed herewith
32.1	Section 1350 Certification of Chief Executive Officer.	Filed herewith
32.2	Section 1350 Certification of Chief Financial Officer.	Filed herewith

(a) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form S-3 Registration Statement No. 333-59828 filed April 30, 2001.
(b) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 10-K Report for the year ended December 31, 2001.
(c) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 8-K Report dated April 22, 2011.
(d) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 8-K Report dated August 3, 2011.
(e) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 10-K Report for the year ended December 31, 1999.
(f) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 10-K Report for the year ended December 31, 1996.
(g) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 10-K Annual Report for the year ended December 31, 2003.
(h) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 10-K Annual Report for the year ended December 31, 2002.
(i) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 8-K Report dated July 18, 2008.
(j) We incorporate such exhibit by reference to the like-numbered exhibit in Registrant s Form 8-K Report dated April 20, 2007.
(k) We incorporate such exhibit by reference to the description of such plan in Registrant s definitive proxy statement for its Annual Meeting of Stockholders held on April 21, 2011 filed on March 18, 2011.
(l) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 10-K Annual Report for the year ended December 31, 2009.
(m) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form S-4 registration statement filed June 25, 2010, Registrant s Form 8-K Report dated September 1, 2010 and Registrant s Form 8-K Report dated December 8, 2010.
(n) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 8-K Report dated December 8, 2010.
(o) We incorporate such exhibit by reference to the like-described exhibit in Registrant s Form 10-K Annual Report for the year ended December 31, 2010.
(p) We incorporate such exhibit by reference to the like-described exhibit filed in Registrant s Form S-3 registration statement filed on May 27, 2011.

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SCHEDULE SUPPLEMENTARY INSURANCE INFORMATION

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III SUPPLEMENTARY INSURANCE INFORMATION

Years Ended December 31, 2011, 2010 and 2009

($ in thousands)

Segment	Net Earned Premiums	Net Investment Income	Net Losses And Loss Expenses	Amortization of Deferred Policy Acquisition Costs	Other Underwriting Expenses	Net Premiums Written
Year Ended December 31, 2011						
Personal lines	$ 280,370	$	$ 232,141	$ 44,558	$ 43,487	$ 291,065
Commercial lines	151,100		108,362	24,013	23,437	162,986
Investments		20,858				
	$ 431,470	$ 20,858	$ 340,503	$ 68,571	$ 66,924	$ 454,051
Year Ended December 31, 2010						
Personal lines	$ 260,469	$	$ 196,008	$ 45,719	$ 37,596	$ 268,047
Commercial lines	117,561		78,301	20,635	16,969	123,475
Investments		19,950				
	$ 378,030	$ 19,950	$ 274,309	$ 66,354	$ 54,565	$ 391,522
Year Ended December 31, 2009						
Personal lines	$ 241,844	$	$ 178,040	$ 41,071	$ 34,634	$ 252,487
Commercial lines	113,181		72,795	19,221	16,209	110,742
Investments		20,631				
	$ 355,025	$ 20,631	$ 250,835	$ 60,292	$ 50,843	$ 363,229

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DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III SUPPLEMENTARY INSURANCE INFORMATION, CONTINUED

($ in thousands)

	At December 31,			
Segment	Deferred Policy Acquisition Costs	Liability For Losses And Loss Expenses	Unearned Premiums	Other Policy Claims and Benefits Payable
2011				
Personal lines	$ 23,385	$ 207,047	$ 216,314	$
Commercial lines	13,040	235,361	120,623	
Investments				
	$ 36,425	$ 442,408	$ 336,937	$
2010				
Personal lines	$ 22,872	$ 184,760	$ 197,389	$
Commercial lines	11,574	198,559	99,883	
Investments				
	$ 34,446	$ 383,319	$ 297,272	$

See accompanying Report and Consent of Independent Registered Public Accounting Firm.

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SIGNATURES

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

DONEGAL GROUP INC.

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

Date: March 12, 2012

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Donald H. Nikolaus Donald H. Nikolaus	President and a Director (principal executive officer)	March 12, 2012
/s/ Jeffrey D. Miller Jeffrey D. Miller	Senior Vice President and Chief Financial Officer (principal financial and accounting officer)	March 12, 2012
/s/ Robert S. Bolinger Robert S. Bolinger	Director	March 12, 2012
/s/ Patricia A. Gilmartin Patricia A. Gilmartin	Director	March 12, 2012
/s/ Philip H. Glatfelter, II Philip H. Glatfelter, II	Director	March 12, 2012
/s/ Jack L. Hess Jack L. Hess	Director	March 12, 2012
/s/ Kevin M. Kraft, Sr. Kevin M. Kraft, Sr.	Director	March 12, 2012
/s/ John J. Lyons John J. Lyons	Director	March 12, 2012
/s/ Jon M. Mahan Jon M. Mahan	Director	March 12, 2012
/s/ S. Trezevant Moore, Jr. S. Trezevant Moore, Jr.	Director	March 12, 2012
/s/ R. Richard Sherbahn R. Richard Sherbahn	Director	March 12, 2012
/s/ Richard D. Wampler, II Richard D. Wampler, II	Director	March 12, 2012