

DONEGAL GROUP INC  
Form 10-Q  
November 07, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2016**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number 0-15341**

**Donegal Group Inc.**

**(Exact name of registrant as specified in its charter)**

**Delaware** **23-2424711**  
**(State or other jurisdiction of** **(I.R.S. Employer**  
**incorporation or organization)** **Identification No.)**  
**1195 River Road, P.O. Box 302, Marietta, PA 17547**  
**(Address of principal executive offices) (Zip code)**  
**(717) 426-1931**  
**(Registrant's telephone number, including area code)**  
**Not applicable**  
**(Former name, former address and former fiscal year, if changed since last report)**

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 21,231,379 shares of Class A Common Stock, par value \$0.01 per share, and 5,576,775 shares of Class B Common Stock, par value \$0.01 per share, outstanding on October 31, 2016.



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DONEGAL GROUP INC.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****Donegal Group Inc. and Subsidiaries****Consolidated Balance Sheets**

	<b>September 30, 2016</b>	<b>December 31, 2015</b>
	(Unaudited)	
<b><u>Assets</u></b>		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	\$ 332,272,969	\$ 310,258,704
Available for sale, at fair value	515,821,393	501,393,559
Equity securities, available for sale, at fair value	46,311,943	37,260,821
Investment in affiliate	40,145,067	38,476,708
Short-term investments, at cost, which approximates fair value	9,251,153	13,432,482
Total investments	943,802,525	900,822,274
Cash	32,130,534	28,139,144
Accrued investment income	6,817,760	5,991,197
Premiums receivable	165,761,900	141,267,411
Reinsurance receivable	259,428,626	259,728,113
Deferred policy acquisition costs	57,404,289	52,108,388
Deferred tax asset, net	14,721,101	19,443,807
Prepaid reinsurance premiums	127,431,503	113,522,505
Property and equipment, net	6,705,671	7,027,143
Federal income taxes receivable	1,823,273	1,487,656
Goodwill	5,625,354	5,625,354
Other intangible assets	958,010	958,010
Other	1,453,864	1,713,413
Total assets	\$ 1,624,064,410	\$ 1,537,834,415
<b><u>Liabilities and Stockholders Equity</u></b>		
<b>Liabilities</b>		
Unpaid losses and loss expenses	\$ 594,267,943	\$ 578,205,109
Unearned premiums	476,432,783	429,493,203
Accrued expenses	21,067,170	22,460,475
Reinsurance balances payable	3,058,225	3,480,406
Borrowings under lines of credit	74,000,000	81,000,000
Cash dividends declared		3,511,881
Subordinated debentures	5,000,000	5,000,000

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Accounts payable - securities	540,311	582,560
Due to affiliate	3,978,958	3,557,177
Other	1,710,209	2,155,036
<b>Total liabilities</b>	<b>1,180,055,599</b>	<b>1,129,445,847</b>
<b>Stockholders Equity</b>		
Preferred stock, \$.01 par value, authorized 2,000,000 shares; none issued		
Class A common stock, \$.01 par value, authorized 40,000,000 shares, issued 24,189,133 and 23,501,805 shares and outstanding 21,186,545 and 20,499,217 shares	241,892	235,018
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 5,649,240 shares and outstanding 5,576,775 shares	56,492	56,492
Additional paid-in capital	231,885,764	219,525,301
Accumulated other comprehensive income	6,340,292	773,744
Retained earnings	246,710,728	229,024,370
Treasury stock, at cost	(41,226,357)	(41,226,357)
<b>Total stockholders equity</b>	<b>444,008,811</b>	<b>408,388,568</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 1,624,064,410</b>	<b>\$ 1,537,834,415</b>

See accompanying notes to consolidated financial statements.

**Table of Contents****Donegal Group Inc. and Subsidiaries****Consolidated Statements of Income**

(Unaudited)

	<b>Three Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>Revenues:</b>		
Net premiums earned	\$ 166,809,851	\$ 153,096,075
Investment income, net of investment expenses	5,581,238	5,399,080
Net realized investment gains (losses) (includes \$1,018,415 and (\$754,050) accumulated other comprehensive income (loss) reclassifications)	1,018,415	(754,050)
Lease income	163,779	178,827
Installment payment fees	1,380,024	1,473,447
Equity in earnings of Donegal Financial Services Corporation	357,956	408,405
<b>Total revenues</b>	<b>175,311,263</b>	<b>159,801,784</b>
<b>Expenses:</b>		
Net losses and loss expenses	111,174,963	102,233,708
Amortization of deferred policy acquisition costs	27,524,000	25,036,000
Other underwriting expenses	28,340,135	24,155,566
Policyholder dividends	1,143,026	886,210
Interest	473,917	188,000
Other expenses	226,183	301,367
<b>Total expenses</b>	<b>168,882,224</b>	<b>152,800,851</b>
<b>Income before income tax expense</b>	<b>6,429,039</b>	<b>7,000,933</b>
Income tax expense (includes \$356,446 and (\$263,918) income tax expense (benefit) from reclassification items)	1,615,635	1,314,102
<b>Net income</b>	<b>\$ 4,813,404</b>	<b>\$ 5,686,831</b>
Earnings per common share:		
Class A common stock - basic	\$ 0.19	\$ 0.21
Class A common stock - diluted	\$ 0.18	\$ 0.21
Class B common stock - basic and diluted	\$ 0.16	\$ 0.18

**Donegal Group Inc. and Subsidiaries****Consolidated Statements of Comprehensive Income**

(Unaudited)

	<b>Three Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
Net income	\$ 4,813,404	\$ 5,686,831
Other comprehensive (loss) income, net of tax		
Unrealized (loss) gain on securities:		
Unrealized holding (loss) gain during the period, net of income tax (benefit) expense of (\$595,724) and 463,221	(1,106,346)	860,268
Reclassification adjustment for (gains) losses included in net income, net of income tax expense (benefit) of \$356,446 and (\$263,918)	(661,969)	490,132
Other comprehensive (loss) income	(1,768,315)	1,350,400
<b>Comprehensive income</b>	<b>\$ 3,045,089</b>	<b>\$ 7,037,231</b>

See accompanying notes to consolidated financial statements.



**Table of Contents****Donegal Group Inc. and Subsidiaries****Consolidated Statements of Income**

(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>Revenues:</b>		
Net premiums earned	\$ 487,227,767	\$ 450,083,676
Investment income, net of investment expenses	16,471,630	15,505,429
Net realized investment gains (includes \$2,204,533 and \$682,932 accumulated other comprehensive income reclassifications)	2,204,533	682,932
Lease income	514,768	568,552
Installment payment fees	4,109,550	4,473,905
Equity in earnings of Donegal Financial Services Corporation	698,658	1,276,692
<b>Total revenues</b>	<b>511,226,906</b>	<b>472,591,186</b>
<b>Expenses:</b>		
Net losses and loss expenses	309,946,943	296,012,311
Amortization of deferred policy acquisition costs	80,034,000	73,872,000
Other underwriting expenses	81,557,159	73,192,072
Policyholder dividends	2,729,595	2,491,919
Interest	1,286,279	908,615
Other expenses	1,179,660	1,704,680
<b>Total expenses</b>	<b>476,733,636</b>	<b>448,181,597</b>
<b>Income before income tax expense</b>	<b>34,493,270</b>	<b>24,409,589</b>
Income tax expense (includes \$771,587 and \$239,026 income tax expense from reclassification items)	9,246,299	5,403,395
<b>Net income</b>	<b>\$ 25,246,971</b>	<b>\$ 19,006,194</b>
Earnings per common share:		
Class A common stock - basic	\$ 0.98	\$ 0.71
Class A common stock - diluted	\$ 0.95	\$ 0.69
Class B common stock - basic and diluted	\$ 0.88	\$ 0.63

**Donegal Group Inc. and Subsidiaries****Consolidated Statements of Comprehensive Income**

(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
Net income	\$ 25,246,971	\$ 19,006,194
Other comprehensive income (loss), net of tax		
Unrealized gain (loss) on securities:		
Unrealized holding gain (loss) during the period, net of income tax expense (benefit) of \$3,768,959 and (\$1,141,726)	6,999,494	(2,120,347)
Reclassification adjustment for gains included in net income, net of income tax expense of \$771,587 and \$239,026	(1,432,946)	(443,906)
Other comprehensive income (loss)	5,566,548	(2,564,253)
<b>Comprehensive income</b>	<b>\$ 30,813,519</b>	<b>\$ 16,441,941</b>

See accompanying notes to consolidated financial statements.

**Table of Contents****Donegal Group Inc. and Subsidiaries****Consolidated Statement of Stockholders' Equity**

(Unaudited)

**Nine Months Ended September 30, 2016**

	Class A Shares	Class B Shares	Class A Amount	Class B Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, September 30, 2015	23,501,805	5,649,240	\$ 235,018	\$ 56,492	\$ 219,525,301	\$ 773,744	\$ 229,024,370	\$ (41,226,357)	\$ 408,388,757
Issuance of common stock	104,271		1,043		1,389,022				1,391,336
Share-based compensation	583,057		5,831		10,396,351				10,402,019
Net income							25,246,971		25,246,971
Dividends paid							(6,985,523)		(6,985,523)
Repurchase of stock					575,090		(575,090)		
Other comprehensive income						5,566,548			5,566,548
Balance, September 30, 2016	24,189,133	5,649,240	\$ 241,892	\$ 56,492	\$ 231,885,764	\$ 6,340,292	\$ 246,710,728	\$ (41,226,357)	\$ 444,008,726

See accompanying notes to consolidated financial statements.

**Table of Contents****Donegal Group Inc. and Subsidiaries****Consolidated Statements of Cash Flows**

(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 25,246,971	\$ 19,006,194
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and other non-cash items	5,365,877	2,890,128
Net realized investment gains	(2,204,533)	(682,932)
Equity in earnings of Donegal Financial Services Corporation	(698,658)	(1,276,692)
Changes in assets and liabilities:		
Losses and loss expenses	16,062,834	30,888,062
Unearned premiums	46,939,580	32,671,922
Premiums receivable	(24,494,489)	(13,301,356)
Deferred acquisition costs	(5,295,901)	(5,212,051)
Deferred income taxes	1,725,335	225,409
Reinsurance receivable	299,487	(6,254,559)
Prepaid reinsurance premiums	(13,908,998)	(1,631,341)
Accrued investment income	(826,563)	(929,722)
Due to affiliate	421,781	(1,655,351)
Reinsurance balances payable	(422,181)	(3,900,348)
Current income taxes	(335,617)	242,849
Accrued expenses	(1,393,305)	(601,830)
Other, net	(185,278)	(1,943,559)
Net adjustments	21,049,371	29,528,629
Net cash provided by operating activities	46,296,342	48,534,823
<b>Cash Flows from Investing Activities:</b>		
Purchases of fixed maturities, held to maturity	(35,461,529)	(18,483,546)
Purchases of fixed maturities, available for sale	(127,113,153)	(132,823,136)
Purchases of equity securities, available for sale	(10,753,187)	(9,011,957)
Maturity of fixed maturities:		
Held to maturity	13,603,700	22,416,840
Available for sale	64,406,512	56,293,130
Sales of fixed maturities, available for sale	52,032,208	23,485,311
Sales of equity securities, available for sale	5,068,287	2,704,425
Net purchases of property and equipment	(260,968)	(78,292)
Net decrease in investment in affiliate		675,100

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Net sales (purchases) of short-term investments	4,181,329	(4,302,571)
Net cash used in investing activities	(34,296,801)	(59,124,696)
<b>Cash Flows from Financing Activities:</b>		
Cash dividends paid	(10,497,404)	(10,762,609)
Issuance of common stock	9,489,253	17,106,300
Purchase of treasury stock		(904,675)
Payments on lines of credit	(7,000,000)	(9,500,000)
Borrowings under lines of credit		4,000,000
Net cash used in financing activities	(8,008,151)	(60,984)
Net increase (decrease) in cash	3,991,390	(10,650,857)
Cash at beginning of period	28,139,144	35,578,509
Cash at end of period	\$ 32,130,534	\$ 24,927,652
Cash paid during period - Interest	\$ 1,001,870	\$ 757,175
Net cash paid during period - Taxes	\$ 8,255,000	\$ 4,500,000

See accompanying notes to consolidated financial statements.

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**DONEGAL GROUP INC. AND SUBSIDIARIES**

**(Unaudited)**

**Notes to Consolidated Financial Statements**

**1 - Organization**

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 also own 48.2% of the outstanding stock of Donegal Financial Services Corporation ( DFSC ), a grandfathered unitary savings and loan holding company that owns Union Community Bank ( UCB ), a state savings bank. Donegal Mutual owns the remaining 51.8% of the outstanding stock of DFSC.

We have four segments: our investment function, our personal lines of insurance, our commercial lines of insurance and our investment in DFSC. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies.

At September 30, 2016, Donegal Mutual held approximately 47% of our outstanding Class A common stock and approximately 83% of our outstanding Class B common stock. This ownership provides Donegal Mutual with approximately 73% of the total voting power of our outstanding common stock. We believe Donegal Mutual's voting control of us benefits us for the reasons we describe in our Annual Reports on Form 10-K and in our proxy statements. Our insurance subsidiaries and Donegal Mutual have interrelated operations due to a pooling agreement and other intercompany agreements and transactions. 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, Donegal Mutual and Atlantic States 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 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 Donegal Mutual and our insurance subsidiaries offer relate generally to specific risk profiles targeted within similar classes of business, such as preferred tier products

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.

On July 18, 2013, our board of directors authorized a share repurchase program pursuant to which we have the authority to purchase up to 500,000 additional shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the SEC and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the nine months ended September 30, 2016. We purchased 57,658 shares of our Class A common stock under this program during the nine months ended September 30, 2015. We have purchased a total of 57,658 shares of our Class A common stock under this program from its inception through September 30, 2016.

**Table of Contents****2 - Basis of Presentation**

Our financial information for the interim periods included in this Form 10-Q Report is unaudited; however, our financial information we include in this Form 10-Q Report reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of our management, are necessary for a fair presentation of our financial position, results of operations and cash flows for those interim periods. Our results of operations for the nine months ended September 30, 2016 are not necessarily indicative of the results of operations we expect for the year ending December 31, 2016.

You should read the interim financial statements we include in this Form 10-Q Report in conjunction with the financial statements and the notes to our financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2015.

**3 - Earnings Per Share**

We have two classes of common stock, which we refer to as our Class A common stock and our Class B common stock. Our certificate of incorporation provides that whenever our board of directors declares a dividend on our Class B common stock, our board of directors shall simultaneously declare a dividend on our Class A common stock that is payable to the holders of our Class A common stock at the same time and as of the same record date at a rate that is at least 10% greater than the rate at which our board of directors declared a dividend on our Class B common stock. Accordingly, we use the two-class method to compute our 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 we have declared and an allocation of our remaining undistributed earnings using a participation percentage that reflects the dividend rights of each class. The table below presents for the periods indicated a reconciliation of the numerators and denominators we used to compute basic and diluted net income per share for each class of our common stock:

	<b>Three Months Ended September 30,</b>			
	<b>2016</b>		<b>2015</b>	
	Class	Class	Class	Class
	A	B	A	B
	(in thousands, except per share data)			
<b>Basic net income per share:</b>				
<b>Numerator:</b>				
Allocation of net income	\$ 3,901	\$ 912	\$ 4,663	\$ 1,024
<b>Denominator:</b>				
Weighted-average shares outstanding	21,078	5,577	22,442	5,577
Basic net income per share	\$ 0.19	\$ 0.16	\$ 0.21	\$ 0.18
<b>Diluted net income per share:</b>				
<b>Numerator:</b>				
Allocation of net income	\$ 3,901	\$ 912	\$ 4,663	\$ 1,024
<b>Denominator:</b>				



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Number of shares used in basic computation	21,078	5,577	22,442	5,577
Weighted-average shares effect of dilutive securities				
Add: Director and employee stock options	831		242	
Number of shares used in diluted computation	21,909	5,577	22,684	5,577
Diluted net income per share	\$ 0.18	\$ 0.16	\$ 0.21	\$ 0.18

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	<b>Nine Months Ended September 30,</b>			
	<b>2016</b>		<b>2015</b>	
	Class Class A	Class B	Class A	Class B
(in thousands, except per share data)				
<b>Basic net income per share:</b>				
Numerator:				
Allocation of net income	\$ 20,329	\$ 4,918	\$ 15,502	\$ 3,504
Denominator:				
Weighted-average shares outstanding	20,791	5,577	21,996	5,577
Basic net income per share	\$ 0.98	\$ 0.88	\$ 0.71	\$ 0.63
<b>Diluted net income per share:</b>				
Numerator:				
Allocation of net income	\$ 20,329	\$ 4,918	\$ 15,502	\$ 3,504
Denominator:				
Number of shares used in basic computation	20,791	5,577	21,996	5,577
Weighted-average shares effect of dilutive securities				
Add: Director and employee stock options	560		400	
Number of shares used in diluted computation	21,351	5,577	22,396	5,577
Diluted net income per share	\$ 0.95	\$ 0.88	\$ 0.69	\$ 0.63

We did not include outstanding options to purchase the following number of shares of Class A common stock in our computation of diluted earnings per share because the exercise price of the options exceeded the average market price of our Class A common stock during the applicable periods:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
Number of options to purchase Class A shares excluded		4,014,501		

**4 - Reinsurance**

Atlantic States and Donegal Mutual have participated in a pooling agreement since 1986 under which each company places all of its direct written premiums into the pool the pooling agreement established, and Atlantic States and Donegal Mutual then share the underwriting results of the pool in accordance with the terms of the pooling agreement. Atlantic States has an 80% share of the results of the pool, and Donegal Mutual has a 20% share of the results of the pool.

Our insurance subsidiaries and Donegal Mutual purchase certain third-party reinsurance on a combined basis. Le Mars, MICO, Peninsula and Sheboygan also purchase separate third-party reinsurance that provides coverage that we believe is commensurate with their relative size and risk 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 following information describes the external reinsurance our insurance subsidiaries have in place for 2016:

excess of loss reinsurance, under which Donegal Mutual and our insurance subsidiaries recover, through a series of reinsurance agreements, losses over a set retention (generally \$1.0 million), and

catastrophe reinsurance, under which Donegal Mutual and our insurance subsidiaries recover, through a series of reinsurance agreements, 100% of an accumulation of many losses resulting from a single event, including natural

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disasters, over a set retention (generally \$5.0 million) and after exceeding an annual aggregate deductible (generally \$1.0 million) up to aggregate losses of \$170.0 million per occurrence.

Our insurance subsidiaries and Donegal Mutual also purchase facultative reinsurance to cover exposures in excess of the covered limits of their third-party reinsurance agreements.

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

We have made no significant changes to our third-party reinsurance or the reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the nine months ended September 30, 2016.

**5 - Investments**

The amortized cost and estimated fair values of our fixed maturities and equity securities at September 30, 2016 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
<b>Held to Maturity</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 59,254	\$ 3,130	\$ 7	\$ 62,377
Obligations of states and political subdivisions	122,203	14,292	4	136,491
Corporate securities	86,582	3,360	598	89,344
Mortgage-backed securities	64,234	2,425		66,659
Totals	\$ 332,273	\$ 23,207	\$ 609	\$ 354,871
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
<b>Available for Sale</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 36,009	\$ 368	\$ 2	\$ 36,375
Obligations of states and political subdivisions	184,068	10,219	11	194,276
Corporate securities	88,826	2,156	141	90,841
Mortgage-backed securities	190,936	3,444	51	194,329
Fixed maturities	499,839	16,187	205	515,821
Equity securities	41,806	4,917	411	46,312

Totals	\$ 541,645	\$ 21,104	\$ 616	\$ 562,133
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At September 30, 2016, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of \$229.6 million and an amortized cost of \$213.6 million. Our holdings at September 30, 2016 also included special revenue bonds with an aggregate fair value of \$101.2 million and an amortized cost of \$92.7 million. With respect to both categories of those bonds at September 30, 2016, we held no securities of any issuer that constituted more than 10% of our holdings of either bond category. Education bonds and water and sewer utility bonds represented 62% and 24%, respectively, of our total investments in special revenue bonds based on the carrying values of these investments at September 30, 2016. Many of the issuers of the special revenue bonds we held at September 30, 2016 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held at September 30, 2016 were similar to general obligation bonds.

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The amortized cost and estimated fair values of our fixed maturities and equity securities at December 31, 2015 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
<b>Held to Maturity</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 51,194	\$ 1,544	\$	\$ 52,738
Obligations of states and political subdivisions	119,115	10,828	119	129,824
Corporate securities	65,307	816	1,561	64,562
Mortgage-backed securities	74,643	1,181	149	75,675
Totals	\$ 310,259	\$ 14,369	\$ 1,829	\$ 322,799

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
<b>Available for Sale</b>				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 37,080	\$ 160	\$ 51	\$ 37,189
Obligations of states and political subdivisions	223,769	13,151	364	236,556
Corporate securities	73,474	350	1,012	72,812
Mortgage-backed securities	154,687	1,045	896	154,836
Fixed maturities	489,010	14,706	2,323	501,393
Equity securities	35,765	2,269	773	37,261
Totals	\$ 524,775	\$ 16,975	\$ 3,096	\$ 538,654

At December 31, 2015, our holdings of obligations of states and political subdivisions included general obligation bonds with an aggregate fair value of \$256.9 million and an amortized cost of \$241.1 million. Our holdings also included special revenue bonds with an aggregate fair value of \$109.5 million and an amortized cost of \$101.8 million. With respect to both categories of bonds, we held no securities of any issuer that comprised more than 10% of that category at December 31, 2015. Education bonds and water and sewer utility bonds represented 57% and 26%, respectively, of our total investments in special revenue bonds based on their carrying values at December 31, 2015. Many of the issuers of the special revenue bonds we held at December 31, 2015 have the authority to impose ad valorem taxes. In that respect, many of the special revenue bonds we held are similar to general obligation bonds.

We made reclassifications from available for sale to held to maturity of certain fixed maturities at fair value on November 30, 2013. We segregated within accumulated other comprehensive income the net unrealized losses of \$15.1 million arising prior to the November 30, 2013 reclassification date for fixed maturities we reclassified from

available for sale to held to maturity. We are amortizing this balance over the remaining life of the related securities as an adjustment to yield in a manner consistent with the accretion of discount on the same fixed maturities. We recorded amortization of \$1.0 million and \$905,446 in accumulated other comprehensive income during the nine months ended September 30, 2016 and 2015, respectively. At September 30, 2016 and December 31, 2015, net unrealized losses of \$11.3 million and \$12.3 million, respectively, remained within accumulated other comprehensive income.

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We show below the amortized cost and estimated fair value of our fixed maturities at September 30, 2016 by contractual maturity. Expected maturities may differ from contractual maturities because issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

	<b>Amortized Cost</b>	<b>Estimated Fair Value</b>
	(in thousands)	
<b>Held to maturity</b>		
Due in one year or less	\$ 9,643	\$ 9,657
Due after one year through five years	42,967	44,275
Due after five years through ten years	86,925	92,926
Due after ten years	128,504	141,354
Mortgage-backed securities	64,234	66,659
<b>Total held to maturity</b>	<b>\$ 332,273</b>	<b>\$ 354,871</b>
<b>Available for sale</b>		
Due in one year or less	\$ 36,476	\$ 37,158
Due after one year through five years	115,204	119,709
Due after five years through ten years	105,689	109,631
Due after ten years	51,534	54,994
Mortgage-backed securities	190,936	194,329
<b>Total available for sale</b>	<b>\$ 499,839</b>	<b>\$ 515,821</b>

Gross realized gains and losses from investments before applicable income taxes for the three and nine months ended September 30, 2016 and 2015 were as follows:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	(in thousands)			
<b>Gross realized gains:</b>				
Fixed maturities	\$ 289	\$ 7	\$ 2,129	\$ 974
Equity securities	1,170	30	1,226	733
	1,459	37	3,355	1,707
<b>Gross realized losses:</b>				
Fixed maturities	22	27	280	105
Equity securities	419	764	870	919
	441	791	1,150	1,024
<b>Net realized gains (losses)</b>	<b>\$ 1,018</b>	<b>\$ (754)</b>	<b>\$ 2,205</b>	<b>\$ 683</b>



We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at September 30, 2016 as follows:

	Less Than 12 Months		More Than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 2,988	\$ 9	\$	\$
Obligations of states and political subdivisions	4,248	13	722	2
Corporate securities	21,006	205	2,911	534
Mortgage-backed securities	20,567	49	831	2
Equity securities	4,515	308	163	103
Totals	\$ 53,324	\$ 584	\$ 4,627	\$ 641

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We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2015 as follows:

	Less Than 12 Months		More Than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
				(in thousands)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 10,168	\$ 51	\$	\$
Obligations of states and political subdivisions	19,437	483		
Corporate securities	69,482	1,615	11,324	958
Mortgage-backed securities	105,300	876	7,538	168
Equity securities	9,245	773		
Totals	\$ 213,632	\$ 3,798	\$ 18,862	\$ 1,126

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 equity security investment to be other than temporary. We monitor all investments individually 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 our original cost and has been in such an unrealized loss position for more than six months. We held seven equity securities that were in an unrealized loss position at September 30, 2016. 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, issuer or geographic events that have negatively impacted the value of a security and rating agency downgrades. We held 55 debt securities that were in an unrealized loss position at September 30, 2016. 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 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 on mortgage-backed debt securities using anticipated prepayments.

We account for our investment in affiliate using the equity method of accounting. Under this method, we record our investment at cost, with adjustments for our share of our affiliate's earnings and losses as well as changes in the equity of our affiliate due to unrealized gains and losses. Our investment in affiliate represents our 48.2% ownership interest in DFSC. 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 September 30, 2016 and December 31, 2015 and for the three and nine months ended September 30, 2016 and 2015, respectively, from the financial statements of DFSC. The financial information of DFSC at September 30, 2016 and 2015 and for the three and nine months then ended is unaudited.

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Balance sheets:	<b>September 30, 2016</b>	<b>December 31, 2015</b>
	(in thousands)	
Total assets	\$ 522,118	\$ 507,139
Total liabilities	\$ 438,942	\$ 427,423
Stockholders equity	83,176	79,716
Total liabilities and stockholders equity	\$ 522,118	\$ 507,139

Income statements:	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>	<b>2016</b>	<b>2015</b>
	(in thousands)			
Net income	\$ 742	\$ 847	\$ 1,449	\$ 2,372

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We evaluate the performance of our personal lines and commercial lines segments based upon the underwriting results of our insurance subsidiaries using statutory accounting principles ( SAP ) that various state insurance departments prescribe or permit. Our management uses SAP to measure the performance of our insurance subsidiaries instead of United States generally accepted accounting principles ( GAAP ). Financial data by segment for the three and nine months ended September 30, 2016 and 2015 is as follows:

	<b>Three Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
	(in thousands)	
<b>Revenues:</b>		
Premiums earned		
Commercial lines	\$ 75,571	\$ 66,456
Personal lines	91,239	86,640
GAAP premiums earned	166,810	153,096
Net investment income	5,581	5,399
Realized investment gains (losses)	1,018	(754)
Equity in earnings of DFSC	358	408
Other	1,544	1,653
Total revenues	\$ 175,311	\$ 159,802
<b>Income before income taxes:</b>		
<b>Underwriting (loss) income:</b>		
Commercial lines	\$ 3,701	\$ 4,447
Personal lines	(5,861)	(3,727)
SAP underwriting (loss) income	(2,160)	720
GAAP adjustments	788	65
GAAP underwriting (loss) income	(1,372)	785
Net investment income	5,581	5,399
Realized investment gains (losses)	1,018	(754)
Equity in earnings of DFSC	358	408
Other	844	1,163
Income before income taxes	\$ 6,429	\$ 7,001

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	<b>Nine Months Ended September 30,</b>	
	<b>2016</b>	<b>2015</b>
	(in thousands)	
<b>Revenues:</b>		
Premiums earned		
Commercial lines	\$ 218,405	\$ 193,036
Personal lines	268,823	257,048
GAAP premiums earned	487,228	450,084
Net investment income	16,472	15,505
Realized investment gains	2,205	683
Equity in earnings of DFSC	699	1,277
Other	4,623	5,042
<b>Total revenues</b>	<b>\$ 511,227</b>	<b>\$ 472,591</b>
<b>Income before income taxes:</b>		
<b>Underwriting income (loss):</b>		
Commercial lines	\$ 14,118	\$ 6,449
Personal lines	(6,953)	(6,499)
SAP underwriting income (loss)	7,165	(50)
GAAP adjustments	5,795	4,565
GAAP underwriting income	12,960	4,515
Net investment income	16,472	15,505
Realized investment gains	2,205	683
Equity in earnings of DFSC	699	1,277
Other	2,157	2,430
<b>Income before income taxes</b>	<b>\$ 34,493</b>	<b>\$ 24,410</b>

**7 - Borrowings****Lines of Credit**

In July 2016, 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. The line of credit expires in July 2019. We have the right to request a one-year extension of the credit agreement as of each anniversary date of the credit agreement. At September 30, 2016, we had \$39.0 million in outstanding borrowings and had the ability to borrow an additional \$21.0 million at interest rates equal to M&T 's current prime rate or the then current LIBOR rate plus 2.25%. The interest rate on our outstanding borrowings from M&T is adjustable quarterly, and, at September 30, 2016, that interest rate was 2.78%. 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. These covenants include minimum levels of our net worth, leverage ratio, statutory surplus and the A.M. Best ratings of our insurance subsidiaries. We were in compliance with all requirements of the M&T credit agreement during the nine months ended September 30, 2016.

MICO is a member of the Federal Home Loan Bank ( FHLB ) of Indianapolis. Through its membership, MICO has the ability to issue debt to the FHLB of Indianapolis in exchange for cash advances. MICO had no outstanding borrowings with the FHLB of Indianapolis at September 30, 2016. The table below presents the amount of FHLB of Indianapolis stock MICO purchased, collateral pledged and assets related to MICO s membership at September 30, 2016.

FHLB of Indianapolis stock purchased and owned	\$ 236,700
Collateral pledged, at par (carrying value \$2,180,650)	2,177,558
Borrowing capacity currently available	2,143,057

Atlantic States is a member of the FHLB of Pittsburgh. Through its membership, Atlantic States has the ability to issue debt to the FHLB of Pittsburgh in exchange for cash advances. Atlantic States had \$35.0 million in outstanding advances at

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September 30, 2016. The interest rate on the advances was .59% at September 30, 2016. The table below presents the amount of FHLB of Pittsburgh stock Atlantic States purchased, collateral pledged and assets related to Atlantic States membership in the FHLB of Pittsburgh at September 30, 2016.

FHLB of Pittsburgh stock purchased and owned	\$ 1,574,700
Collateral pledged, at par (carrying value \$36,058,067)	36,085,816
Borrowing capacity currently available	310,732

**Subordinated Debentures**

Donegal Mutual holds a \$5.0 million surplus note that MICO issued to increase MICO's statutory surplus. The surplus note carries an interest rate of 5.00%, and any repayment of principal or payment of interest on the surplus note requires prior approval of the Michigan Department of Insurance and Financial Services.

**8 - Share Based Compensation**

We measure all share-based payments to employees, including grants of stock options, and use a fair-value-based method for the recording of related compensation expense in our consolidated statements of income. In determining the expense we record for stock options granted to directors and employees of our subsidiaries and affiliates, 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, the expected term, the dividend yield and the expected volatility.

We charged compensation expense related to our stock compensation plans against income before income taxes of \$414,696 and \$598,516 for the three months ended September 30, 2016 and 2015, respectively, with a corresponding income tax benefit of \$145,143 and \$209,481, respectively. We charged compensation expense related to our stock compensation plans against income before income taxes of \$2.0 million and \$1.9 million for the nine months ended September 30, 2016 and 2015, respectively, with a corresponding income tax benefit of \$710,584 and \$671,607, respectively. At September 30, 2016, we had \$2.0 million of unrecognized compensation expense related to nonvested share-based compensation granted under our stock compensation plans. We expect to recognize this compensation expense over a weighted average period of approximately 1.3 years.

We received cash from option exercises under all stock compensation plans during the three months ended September 30, 2016 and 2015 of \$3.7 million and \$181,488, respectively. We received cash from option exercises under all stock compensation plans during the nine months ended September 30, 2016 and 2015 of \$7.8 million and \$13.7 million, respectively. We realized actual tax benefits for the tax deductions related to option exercises of \$243,656 and \$4,802 for the three months ended September 30, 2016 and 2015, respectively. We realized actual tax benefits for the tax deductions related to option exercises of \$521,852 and \$424,537 for the nine months ended September 30, 2016 and 2015, respectively.

**9 - Fair Value Measurements**

We account for financial assets using a framework that establishes a hierarchy that ranks the quality and reliability of the inputs, or assumptions, we use 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 and include these investments in Level 2 of the fair value hierarchy. We classify our fixed maturity investments as Level 2. Our fixed maturity investments consist of U.S. Treasury

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securities and obligations of U.S. government corporations and agencies, obligations of states and political subdivisions, corporate securities and mortgage-backed securities.

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. These 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 we obtain from the pricing services are representative of fair values based upon our investment personnel's 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 regularly monitor the market, current trading ranges for similar securities and the 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 September 30, 2016, we received two estimates per security from the pricing services, and we priced substantially all of our Level 1 and Level 2 investments using those prices. In our review of the estimates the pricing services provided at September 30, 2016, we did not identify any material 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. We classify these items as Level 1.

The carrying values we report in our balance sheet for premium receivables and reinsurance receivables and payables for premiums and paid losses and loss expenses approximate their fair values. The carrying amounts we report in our balance sheet for our subordinated debentures and borrowings under lines of credit approximate their fair values. We classify these items as Level 3.

We evaluate our assets and liabilities on a recurring basis to determine the appropriate level at which to classify them for each reporting period.

The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities at September 30, 2016:

Fair Value	Fair Value Measurements Using Quoted Prices in		
	Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

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(in thousands)

U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 36,375	\$	\$ 36,375	\$
Obligations of states and political subdivisions	194,276		194,276	
Corporate securities	90,841		90,841	
Mortgage-backed securities	194,329		194,329	
Equity securities	35,167	35,167		
Total investments in the fair value hierarchy	550,988	35,167	515,821	
Investment measured at net asset value	11,145			
Totals	\$ 562,133	\$ 35,167	\$ 515,821	\$

We did not transfer any investments between Levels 1 and 2 during the nine months ended September 30, 2016.



guidance excludes insurance contracts. The new standard is effective on January 1, 2018. The standard permits the use of either the retrospective or the cumulative effect transition method. We do not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

In February 2015, the FASB issued a new standard that amends the current consolidation guidance affecting both the variable interest entity ( VIE ) and voting interest entity ( VOE ) consolidation models. The standard does not add or remove any of the characteristics in determining if an entity is a VIE or a VOE, but rather, the standard enhances assessment of some of these characteristics. The new standard was effective on December 15, 2015. The adoption of this new guidance did not have a significant impact on our financial position, results of operations or cash flows.

In May 2015, the FASB issued guidance that removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The guidance also removes the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. The guidance instead limits disclosure to investments for which the entity has elected to measure fair value using that practical expedient. The guidance was effective for annual reporting periods beginning after December 15, 2015, and interim reporting periods within those annual reporting periods. The adoption of this new guidance did not have a significant impact on our financial position, results of operations or cash flows.

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In May 2015, the FASB issued guidance that requires entities to provide additional disclosures about their liability for unpaid claims and claim adjustment expenses to increase the transparency of significant estimates. The guidance also requires entities to disclose information about significant changes in methodologies and assumptions used to calculate the liability for unpaid claims and claim adjustment expenses, including the reasons for the changes and the effects on the entities' financial statements, and the timing, frequency and severity of claims. The guidance also requires entities to disclose a rollforward of the liability for unpaid claims and claim adjustment expenses for annual and interim reporting periods. The guidance is effective for annual reporting periods beginning after December 15, 2015, and interim reporting periods within annual reporting periods beginning after December 15, 2016. We do not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

In January 2016, the FASB issued guidance that generally requires entities to measure equity investments at fair value and recognize changes in fair value in their results of operations. The guidance also simplifies the impairment assessment of equity investments without readily determinable fair values by requiring entities to perform a qualitative assessment to identify impairment. The FASB issued other disclosure and presentation improvements related to financial instruments within the guidance. The guidance is effective for annual and interim reporting periods beginning after December 15, 2017. As a result of this guidance, we will reflect changes in the fair value of our equity investments in our results of operations beginning January 1, 2018.

In February 2016, the FASB issued guidance that requires lessees to recognize leases, including operating leases, on the lessee's balance sheet, unless a lease is considered a short-term lease. The guidance also requires entities to make new judgments to identify leases. The guidance is effective for annual and interim reporting periods beginning after December 15, 2018 and permits early adoption. We do not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

In March 2016, the FASB issued guidance that simplifies and improves several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. The guidance is effective for annual and interim reporting periods beginning after December 15, 2016. We do not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

In June 2016, the FASB issued guidance that amends previous guidance on the impairment of financial instruments by adding an impairment model that allows an entity to recognize expected credit losses as an allowance rather than impairments as credit losses are incurred. The new guidance is intended to reduce complexity and result in a more timely recognition of expected credit losses. The guidance is effective for annual and interim reporting periods beginning after December 15, 2019. We do not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

In August 2016, the FASB issued guidance that clarifies how certain cash receipts and cash payments shall be presented and classified in the statement of cash flows. This guidance addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The guidance is effective for annual and interim reporting periods beginning after December 15, 2017. We do not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

We recommend that you read the following information in conjunction with the historical financial information and the footnotes to that financial information we include in this Quarterly Report on Form 10-Q. We also recommend you read Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2015.

#### **Critical Accounting Policies and Estimates**

We combine our financial statements with those of our insurance subsidiaries and present our financial statements on a consolidated basis in accordance with GAAP.

Our insurance subsidiaries make estimates and assumptions that can have a significant effect on amounts and disclosures we report in our financial statements. The most significant estimates relate to the reserves of our insurance subsidiaries for property and casualty insurance unpaid losses and loss expenses, the valuation of investments and the determination of other-than-temporary investment impairments and the policy acquisition costs of our insurance subsidiaries. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts of these liabilities may differ from the estimates we provided. We regularly review our methods for making these estimates and we reflect any adjustment we consider necessary in our current consolidated results of operations.

#### **Liability for Unpaid 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 incurred policyholder claims based on facts and circumstances the insurer knows at that point in time. 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, expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and, consequently, it often becomes necessary for our insurance subsidiaries to refine and adjust their estimates for these liabilities. We reflect any adjustments to our insurance subsidiaries' liabilities for losses and loss expenses in our consolidated results of operations in the period in which our insurance subsidiaries make 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 the 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 monitor their liabilities closely 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 and loss expenses.

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 related 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 the severity of these claims 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 collectability of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries make adjustments in their reserves that they consider appropriate for such changes. Accordingly, our insurance subsidiaries ultimate liability for unpaid losses and loss expenses will likely differ



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from the amount recorded at September 30, 2016. For every 1% change in our insurance subsidiaries' estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately \$3.4 million.

The establishment of appropriate liabilities is an inherently uncertain process and we can provide no assurance that our insurance subsidiaries' ultimate liability will not exceed our insurance subsidiaries' loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, because 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 of future liabilities have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimates of their liability for losses and loss expenses generally reflect actual payments and their evaluation of information received since the prior reporting date.

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

Atlantic States' participation in the pool with Donegal Mutual exposes Atlantic States to adverse loss development on the business of Donegal Mutual that the pool includes. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and Donegal Mutual and Atlantic States share proportionately any adverse risk development of the pooled business. The business in the pool is homogeneous and each company has a pro-rata share of the entire pool. Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the intent of the underwriting pool is to produce a more uniform and stable underwriting result from year to year for each company than either would experience individually and to spread the risk of loss between the companies.

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Donegal Mutual and our insurance subsidiaries operate together as the Donegal Insurance Group and share a combined business plan designed to achieve market penetration and underwriting profitability objectives. The products our insurance subsidiaries and Donegal Mutual offer are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier products compared to 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, because the pool homogenizes the risk characteristics of all business Donegal Mutual and Atlantic States write directly and each company shares the results according to each company's participation percentage, each company realizes its percentage share of the underwriting results of the pool. Our insurance subsidiaries' unpaid liability for losses and loss expenses by major line of business at September 30, 2016 and December 31, 2015 consisted of the following:

	<b>September 30, 2016</b>	<b>December 31, 2015</b>
	(in thousands)	
<b>Commercial lines:</b>		
Automobile	\$ 55,079	\$ 53,938
Workers compensation	105,873	99,212
Commercial multi-peril	59,279	54,395
Other	3,639	3,119
<b>Total commercial lines</b>	<b>223,870</b>	<b>210,664</b>
<b>Personal lines:</b>		
Automobile	97,102	93,923
Homeowners	16,947	15,816
Other	2,122	1,651
<b>Total personal lines</b>	<b>116,171</b>	<b>111,390</b>
<b>Total commercial and personal lines</b>	<b>340,041</b>	<b>322,054</b>
<b>Plus reinsurance recoverable</b>	<b>254,227</b>	<b>256,151</b>
<b>Total liability for unpaid losses and loss expenses</b>	<b>\$ 594,268</b>	<b>\$ 578,205</b>

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

Percentage Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance at September 30, 2016		Adjusted Loss and Loss Expense Reserves Net of Reinsurance at December 31, 2015		
	Percentage Change in Stockholders Equity at September 30, 2016(1)	Percentage Change in Stockholders Equity at December 31, 2015(1)	Percentage Change in Stockholders Equity at September 30, 2016(1)	Percentage Change in Stockholders Equity at December 31, 2015(1)	
	(dollars in thousands)				
(10.0)%	\$ 306,037	5.0%	\$ 289,849	5.1%	
(7.5)	314,538	3.7	297,900	3.8	
(5.0)	323,039	2.5	305,951	2.6	
(2.5)	331,540	1.2	314,003	1.3	
Base	340,041		322,054		
2.5	348,542	(1.2)	330,105	(1.3)	
5.0	357,043	(2.5)	338,157	(2.6)	
7.5	365,544	(3.7)	346,208	(3.8)	
10.0	374,045	(5.0)	354,259	(5.1)	

(1) Net of income tax effect.

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## Statutory Combined Ratios

We evaluate our insurance operations by monitoring certain key measures of growth and profitability. In addition to using GAAP-based performance measurements, we also utilize certain non-GAAP financial measures that we believe are valuable in managing our business and for comparison to our peers. These non-GAAP measures are underwriting income, combined ratio and net premiums written. An insurance company's statutory combined ratio is a standard measure of underwriting profitability. This ratio is the sum of the ratio of calendar-year incurred losses and loss expenses to premiums earned; the ratio of expenses incurred for commissions, premium taxes and underwriting expenses to net premiums written and the ratio of dividends to policyholders to premiums earned. The combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. A combined ratio of less than 100 percent generally indicates underwriting profitability. The statutory combined ratio differs from the GAAP combined ratio. In calculating the GAAP combined ratio, we do not deduct installment payment fees from incurred expenses, and we base the expense ratio on premiums earned instead of premiums written. Differences between our GAAP loss ratios reported in our financial statements and our insurance subsidiaries' statutory loss ratios result from anticipating salvage and subrogation recoveries for the GAAP loss ratios but not for the statutory loss ratios. The following table sets forth our insurance subsidiaries' statutory combined ratios by major line of business for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Commercial lines:				
Automobile	110.8%	118.0%	106.5%	106.1%
Workers compensation	86.8	79.1	85.3	89.0
Commercial multi-peril	94.7	92.2	88.5	93.2
Total commercial lines	94.3	92.0	90.3	93.2
Personal lines:				
Automobile	105.9	98.8	102.6	100.0
Homeowners	101.5	108.0	97.1	101.7
Total personal lines	103.6	101.4	99.9	99.8
Total commercial and personal lines	99.5	97.4	95.6	96.9

## Investments

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 an individual 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 the 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 our original cost and has been in such an unrealized loss position for more than six months. We held seven equity securities that were in an unrealized loss position at September 30, 2016. 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 on the debt security. 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 or rating agency

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downgrades. We held 55 debt securities that were in an unrealized loss position at September 30, 2016. 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 our results of operations for the first nine months of 2016 or 2015.

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 we could realize 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. 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 we obtain from the pricing services are representative of fair values based upon the general market knowledge of our investment personnel, 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 September 30, 2016, we received two estimates per security from the pricing services, and we priced substantially all of our Level 1 and Level 2 investments using those prices. In our review of the estimates the pricing services provided at September 30, 2016, we did not identify any material discrepancies, and we did not make any adjustments to the estimates the pricing services provided.

**Policy Acquisition Costs**

Our insurance subsidiaries defer their policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that relate directly to the successful acquisition of insurance policies. We amortize these costs over the period in which our insurance subsidiaries earn the related premiums. The method we follow in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. This method gives effect to the premiums to be earned, related investment income, losses and loss expenses and certain other costs we expect to incur as our insurance subsidiaries earn the premiums.

**Results of Operations - Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015**

*Net Premiums Written.* Our insurance subsidiaries net premiums written for the three months ended September 30, 2016 were \$171.9 million, an increase of \$13.0 million, or 8.2%, from the \$158.9 million of net premiums written for the third quarter of 2015. We attribute the increase to the impact of premium rate increases and an increase in the writing of commercial lines of business. Personal lines net premiums written increased \$5.2 million, or 5.6%, for the third quarter of 2016 compared to the third quarter of 2015. The increase was attributable primarily to premium rate increases our insurance subsidiaries implemented throughout 2015 and 2016. Commercial lines net premiums written increased \$7.8 million, or 12.0%, for the third quarter of 2016 compared to the third quarter of 2015. The increase was primarily attributable to premium rate increases and increased writings of new commercial accounts.

*Net Premiums Earned.* Our insurance subsidiaries' net premiums earned for the third quarter of 2016 were \$166.8 million, an increase of \$13.7 million, or 9.0%, compared to \$153.1 million for the third quarter of 2015, reflecting increases in net premiums written during 2016 and 2015. Our insurance subsidiaries earn premiums and recognize them as revenue over the terms of their policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding 12-month period compared to the comparable period one year earlier.

*Investment Income.* Our net investment income increased to \$5.6 million for the third quarter of 2016, compared to \$5.4 million for the third quarter of 2015. We attribute the increase primarily to an increase in average invested assets.

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*Net Realized Investment Gains (Losses).* Net realized investment gains for the third quarter of 2016 were \$1.0 million, compared to net realized investment losses of \$754,050 for the third quarter of 2015. The net realized investment gains for the third quarter of 2016 resulted primarily from unrealized gains within a limited partnership that invests in equity securities. The net realized investment losses for the third quarter of 2015 resulted primarily from unrealized losses within the limited partnership. We did not recognize any impairment losses in our investment portfolio during the third quarters of 2016 or 2015.

*Equity in Earnings of DFSC.* Our equity in the earnings of DFSC was \$357,956 for the third quarter of 2016, compared to \$408,405 for the third quarter of 2015.

*Losses and Loss Expenses.* Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, for the third quarter of 2016 was 66.6%, a slight decrease from our insurance subsidiaries' loss ratio of 66.8% for the third quarter of 2015. On a statutory basis, our insurance subsidiaries' commercial lines loss ratio was 62.5% for the third quarter of 2016, compared to 62.3% for the third quarter of 2015, primarily due to an increase in the workers' compensation loss ratio. The personal lines statutory loss ratio of our insurance subsidiaries increased to 70.4% for the third quarter of 2016, compared to 69.9% for the third quarter of 2015, primarily due to an increase in the personal automobile loss ratio. Our insurance subsidiaries experienced favorable loss reserve development of approximately \$1.6 million during the third quarter of 2016 in their reserves for prior accident years, compared to unfavorable loss reserve development of approximately \$1.5 million during the third quarter of 2015. The improvement in loss reserve development patterns occurred primarily within our insurance subsidiaries' commercial multi-peril and personal automobile reserves.

*Underwriting Expenses.* The expense ratio for an insurance company is the ratio of policy acquisition costs and other underwriting expenses to premiums earned. The expense ratio of our insurance subsidiaries was 33.5% for the third quarter of 2016, compared to 32.1% for the third quarter of 2015. We attribute the 2016 increase primarily to higher underwriting incentive costs in the third quarter of 2016 compared to the third quarter of 2015.

*Combined Ratio.* The combined ratio represents the sum of the loss ratio, the expense ratio and the dividend ratio, which is the ratio of policyholder dividends incurred to premiums earned. Our insurance subsidiaries' combined ratios were 100.8% and 99.5% for the three months ended September 30, 2016 and 2015, respectively.

*Interest Expense.* Our interest expense for the third quarter of 2016 was \$473,917, compared to \$188,000 for the third quarter of 2015. We attribute the increase to higher average borrowings during the third quarter of 2016 compared to the third quarter of 2015.

*Income Taxes.* Income tax expense was \$1.6 million for the third quarter of 2016, representing an effective tax rate of 25.1%, compared to income tax expense of \$1.3 million for the third quarter of 2015, representing an effective tax rate of 18.8%. The effective tax rate in both periods represented an estimate based on our projected annual taxable income. The increase in the effective tax rate reflects our expectation that tax-exempt interest income will represent a lesser proportion of our 2016 taxable income compared to 2015.

*Net Income and Earnings Per Share.* Our net income for the third quarter of 2016 was \$4.8 million, or \$.18 per share of Class A common stock on a diluted basis and \$.16 per share of Class B common stock, compared to net income of \$5.7 million, or \$.21 per share of Class A common stock and \$.18 per share of Class B common stock, for the third quarter of 2015. We had 21.2 million and 22.4 million Class A shares outstanding at September 30, 2016 and 2015, respectively. We had 5.6 million Class B shares outstanding at the end of both periods.



**Results of Operations - Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015**

*Net Premiums Written.* Our insurance subsidiaries' net premiums written for the nine months ended September 30, 2016 were \$520.3 million, an increase of \$39.2 million, or 8.1%, from the \$481.1 million of net premiums written for the comparable period of 2015. We attribute the increase to the impact of premium rate increases and an increase in the writing of commercial lines of business. Personal lines net premiums written increased \$13.4 million, or 5.0%, for the first nine months of 2016 compared to the first nine months of 2015. The increase was attributable primarily to premium rate increases our insurance subsidiaries implemented throughout 2015 and 2016. Commercial lines net premiums written increased \$25.8 million, or 12.1%, for the first nine months of 2016 compared to the first nine months of 2015. The increase was primarily attributable to premium rate increases and increased writings of new commercial accounts.

*Net Premiums Earned.* Our insurance subsidiaries' net premiums earned for the first nine months of 2016 were \$487.2 million, an increase of \$37.1 million, or 8.3%, compared to \$450.1 million for the first nine months of 2015, reflecting increases in net premiums written during 2016 and 2015. Our insurance subsidiaries earn premiums and recognize them as

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revenue over the terms of their policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding 12-month period compared to the comparable period one year earlier.

*Investment Income.* Our net investment income increased to \$16.5 million for the first nine months of 2016, compared to \$15.5 million for the first nine months of 2015. We attribute the increase primarily to an increase in average invested assets.

*Net Realized Investment Gains.* Net realized investment gains for the first nine months of 2016 were \$2.2 million, compared to \$682,932 for the first nine months of 2015. The net realized investment gains for the first nine months of 2016 and 2015 resulted primarily from calls and strategic sales of fixed maturities and equity securities within our investment portfolio. We did not recognize any impairment losses in our investment portfolio during the first nine months of 2016 or 2015.

*Equity in Earnings of DFSC.* Our equity in the earnings of DFSC was \$698,658 for the first nine months of 2016, compared to \$1.3 million for the first nine months of 2015.

*Losses and Loss Expenses.* Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, for the first nine months of 2016 was 63.6%, a decrease from our insurance subsidiaries' loss ratio of 65.8% for the first nine months of 2015. On a statutory basis, our insurance subsidiaries' commercial lines loss ratio was 59.4% for the first nine months of 2016, compared to 62.7% for the first nine months of 2015, primarily due to decreases in the commercial multi-peril and workers' compensation loss ratios. The personal lines statutory loss ratio of our insurance subsidiaries decreased to 67.2% for the first nine months of 2016, compared to 68.1% for the first nine months of 2015, primarily due to a decrease in the homeowners loss ratio. Our insurance subsidiaries experienced unfavorable loss reserve development of approximately \$2.1 million during the first nine months of 2016 in their reserves for prior accident years, compared to approximately \$4.8 million during the first nine months of 2015. The improvement in loss reserve development patterns occurred primarily within our insurance subsidiaries' workers' compensation reserves.

*Underwriting Expenses.* The expense ratio for an insurance company is the ratio of policy acquisition costs and other underwriting expenses to premiums earned. The expense ratio of our insurance subsidiaries was 33.2% for the first nine months of 2016, compared to 32.7% for the first nine months of 2015. We attribute the 2016 increase primarily to higher underwriting incentive costs related to the lower loss ratio in the first nine months of 2016 compared to the first nine months of 2015.

*Combined Ratio.* The combined ratio represents the sum of the loss ratio, the expense ratio and the dividend ratio, which is the ratio of policyholder dividends incurred to premiums earned. Our insurance subsidiaries' combined ratios were 97.3% and 99.0% for the nine months ended September 30, 2016 and 2015, respectively.

*Interest Expense.* Our interest expense for the first nine months of 2016 was \$1.3 million, compared to \$908,615 for the first nine months of 2015. We attribute the increase to higher average borrowings during the first nine months of 2016 compared to the first nine months of 2015.

*Income Taxes.* Income tax expense was \$9.2 million for the first nine months of 2016, representing an effective tax rate of 26.8%, compared to income tax expense of \$5.4 million for the first nine months of 2015, representing an effective tax rate of 22.1%. The effective tax rate in both periods represented an estimate based on our projected annual taxable income. The increase in the effective tax rate reflects our expectation that tax-exempt interest income will represent a lesser proportion of our 2016 taxable income compared to 2015.

*Net Income and Earnings Per Share.* Our net income for the first nine months of 2016 was \$25.2 million, or \$.95 per share of Class A common stock on a diluted basis and \$.88 per share of Class B common stock, compared to net income of \$19.0 million, or \$.69 per share of Class A common stock on a diluted basis and \$.63 per share of Class B common stock, for the first nine months of 2015. We had 21.2 million and 22.4 million Class A shares outstanding at September 30, 2016 and 2015, respectively. We had 5.6 million Class B shares outstanding at the end of both periods.

### **Liquidity and Capital Resources**

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

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Our operations have historically generated sufficient net positive cash flow to fund our commitments and add to our investment portfolio, thereby increasing future investment returns and enhancing our liquidity. The impact of the pooling agreement between Donegal Mutual and Atlantic States has historically been cash-flow positive because of the consistent underwriting profitability of the pool. Donegal Mutual and Atlantic States settle their respective obligations to each other under the pool monthly, thereby resulting in cash flows substantially similar to the cash flows that would result from each company writing the business directly. We have not experienced any unusual variations in the timing of claim payments associated with the loss reserves of our insurance subsidiaries. We maintain significant liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. We structure our fixed-maturity investment portfolio following a laddering approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations should an unexpected variation occur in the future. Our operating activities provided net cash flows in the first nine months of 2016 and 2015 of \$46.3 million and \$48.5 million, respectively.

At September 30, 2016, we had \$39.0 million in outstanding borrowings under our line of credit with M&T and had the ability to borrow an additional \$21.0 million at interest rates equal to M&T's current prime rate or the then current LIBOR rate plus 2.25%. The interest rate on these borrowings was 2.78% at September 30, 2016. At September 30, 2016, Atlantic States had \$35.0 million in outstanding advances with the FHLB of Pittsburgh. The interest rate on these advances was .59% at September 30, 2016.

The following table shows our expected payments for significant contractual obligations at September 30, 2016:

	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
		(in thousands)			
Net liability for unpaid losses and loss expenses of our insurance subsidiaries	\$ 340,041	\$ 158,779	\$ 155,378	\$ 12,372	\$ 13,512
Subordinated debentures	5,000				5,000
Borrowings under lines of credit	74,000	35,000	39,000		
<b>Total contractual obligations</b>	<b>\$ 419,041</b>	<b>\$ 193,779</b>	<b>\$ 194,378</b>	<b>\$ 12,372</b>	<b>\$ 18,512</b>

We estimate the date of payment for the net liability for unpaid losses and loss expenses of our insurance subsidiaries based on historical experience and expectations of future payment patterns. We show the liability net of reinsurance recoverable on unpaid losses and loss expenses to reflect expected future cash flows related to such liability. Amounts Atlantic States assumes pursuant to the pooling agreement with Donegal Mutual represent a substantial portion of our insurance subsidiaries' gross liability for unpaid losses and loss expenses, and amounts Atlantic States cedes pursuant to the pooling agreement represent a substantial portion of our insurance subsidiaries' reinsurance recoverable on unpaid losses and loss expenses. We include cash settlement of Atlantic States' assumed liability from the pool in monthly settlements of pooled activity, as we net amounts ceded to and assumed from the pool. Although Donegal Mutual and we do not anticipate any changes in the pool participation levels in the foreseeable future, any such change would be prospective in nature and therefore would not impact the timing of expected payments by Atlantic States for its percentage share of pooled losses occurring in periods prior to the effective date of such change.

We discuss in Note 7 – Borrowings our estimate of the timing of the amounts for the borrowings under our lines of credit based on their contractual maturities. The borrowings under our lines of credit carry interest rates that vary as we discuss in Note 7 – Borrowings. Based upon the interest rates in effect at September 30, 2016, our annual interest

cost associated with the borrowings under our lines of credit is approximately \$1.3 million. For every 1% change in the interest rate associated with the borrowings under our lines of credit, the effect on our annual interest cost would be approximately \$740,000.

We discuss in Note 7 Borrowings our estimate of the timing of the amounts for the subordinated debentures based on their contractual maturity. The subordinated debentures carry an interest rate of 5%, and any repayment of principal or payment of interest on the subordinated debentures requires prior approval of the Michigan Department of Insurance and Financial Services. Our annual interest cost associated with the subordinated debentures is approximately \$250,000.

On July 18, 2013, our board of directors authorized a share repurchase program pursuant to which we have the authority to purchase up to 500,000 additional shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of applicable rules of the SEC and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the nine months ended September 30, 2016. We purchased

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57,658 shares of our Class A common stock under this program during the nine months ended September 30, 2015. We have purchased a total of 57,658 shares of our Class A common stock under this program from its inception through September 30, 2016.

On October 20, 2016, our board of directors declared quarterly cash dividends of 13.75 cents per share of our Class A common stock and 12.00 cents per share of our Class B common stock, payable on November 15, 2016 to our stockholders of record as of the close of business on November 1, 2016. We are not subject to any restrictions on our payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends by our insurance subsidiaries to us. Dividends from our insurance subsidiaries are our principal source of cash for payment of dividends to our stockholders. Our insurance subsidiaries are subject to regulations that restrict the 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 limit their ability to pay dividends to us. Our insurance subsidiaries' statutory capital and surplus at December 31, 2015 exceeded the amount of statutory capital and surplus necessary to satisfy regulatory requirements, including the RBC requirements, by a significant margin. Our insurance subsidiaries paid \$9.5 million in dividends to us during the first nine months of 2016. Amounts remaining available for distribution to us as dividends from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities in 2016 are \$18.8 million from Atlantic States, \$1.3 million from Southern, \$1.1 million from Le Mars, \$4.2 million from Peninsula, \$325,412 from Sheboygan and \$619,953 from MICO, or a total of approximately \$26.3 million.

At September 30, 2016, we had no material commitments for capital expenditures.

## **Equity Price Risk**

Our portfolio of marketable equity securities, which we carry on our consolidated balance sheets at estimated fair value, has exposure to the risk of loss resulting from an adverse change in prices. We manage this risk by having our investment staff perform an analysis of prospective investments and regular reviews of our portfolio of equity securities.

## **Credit Risk**

Our portfolio of fixed-maturity securities and, to a lesser extent, our portfolio of short-term investments is subject to credit risk, which we define as the potential loss in market value resulting from adverse changes in the borrower's ability to repay its debt. We manage this risk by having our investment staff perform an analysis of prospective investments and regular reviews of our portfolio of fixed-maturity securities. We also limit the percentage and amount of our total investment portfolio that we invest in the securities of any one issuer.

Our insurance subsidiaries provide property and casualty insurance coverages through independent insurance agencies. We bill the majority of this business directly to the insured, although we bill a portion of our commercial business through licensed insurance agents to whom our insurance subsidiaries extend credit in the normal course of business.

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

## **Impact of Inflation**

We establish property and casualty insurance premium rates before we know the amount of unpaid losses and loss expenses or the extent to which inflation may impact such losses and expenses. Consequently, our insurance subsidiaries attempt, in establishing rates, to anticipate the potential impact of inflation.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Our market risk generally represents the risk of gain or loss that may result from the potential change in the fair value of the securities we hold in our investment portfolio as a result of fluctuations in prices and interest rates and, to a lesser extent, our debt obligations. We manage our interest rate risk by maintaining an appropriate relationship between the average duration of our investment portfolio and the approximate duration of our liabilities, i.e., policy claims of our insurance subsidiaries and our debt obligations.

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There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2015 through September 30, 2016.

### **Item 4. 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). Based on such evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, at September 30, 2016, our disclosure controls and procedures were 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 were 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.

#### **Changes in Internal Control Over Financial Reporting**

There has been no change in our internal control over financial reporting during the quarter covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to affect materially, our internal control over financial reporting.

#### **Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995**

We base all statements contained in this Quarterly Report on Form 10-Q that are not historic facts on our current expectations. Such statements are forward-looking in nature (as defined in the Private Securities Litigation Reform Act of 1995) and necessarily involve risks and uncertainties. Forward-looking statements we make may be identified by our use of words such as will, expects, intends, plans, anticipates, believes, seeks, estimates and similar expressions. Our actual results could vary materially from our forward-looking statements. The factors that could cause our actual results to vary materially from the forward-looking statements we have previously made include, but are not limited to, our ability to maintain profitable operations, the adequacy of the loss and loss expense reserves of our insurance subsidiaries, business and economic conditions in the areas in which we and our insurance subsidiaries operate, interest rates, competition from various insurance and other financial businesses, terrorism, the availability and cost of reinsurance, adverse and catastrophic weather events, legal and judicial developments, changes in regulatory requirements, our ability to integrate and manage successfully the companies we may acquire from time to time and the other risks that we describe from time to time in our filings with the SEC. We disclaim any obligation to update such statements or to announce publicly the results of any revisions that we may make to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.



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**Part II. Other Information**

**Item 1. Legal Proceedings.**

None.

**Item 1A. Risk Factors.**

Our business, results of operations and financial condition, and, therefore, the value of our Class A common stock and our Class B common stock, are subject to a number of risks. For a description of certain risks, we refer to Risk Factors in our 2015 Annual Report on Form 10-K we filed with the SEC on March 18, 2016. There have been no material changes in the risk factors we disclosed in that Form 10-K Report during the nine months ended September 30, 2016.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

**Item 3. Defaults upon Senior Securities.**

None.

**Item 4. Removed and Reserved.**

**Item 5. Other Information.**

None.

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<b>Exhibit No.</b>	<b>Description</b>
Exhibit 31.1	Certification of Chief Executive Officer
Exhibit 31.2	Certification of Chief Financial Officer
Exhibit 32.1	Statement of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code
Exhibit 32.2	Statement of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code
Exhibit 101.INS	XBRL Instance Document
Exhibit 101.SCH	XBRL Taxonomy Extension Schema Document
Exhibit 101.PRE	XBRL Taxonomy Presentation Linkbase Document
Exhibit 101.CAL	XBRL Taxonomy Calculation Linkbase Document
Exhibit 101.LAB	XBRL Taxonomy Label Linkbase Document
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

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**Signatures**

Pursuant to the requirements 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.**

November 7, 2016

**By:** /s/ Kevin G. Burke  
Kevin G. Burke, President and Chief Executive Officer

November 7, 2016

**By:** /s/ Jeffrey D. Miller  
Jeffrey D. Miller, Executive Vice President and Chief Financial Officer