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**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

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

For the quarterly period ended **September 30, 2006**

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 0-14697

**HARLEYSVILLE GROUP INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**51-0241172**

(I.R.S. Employer  
Identification No.)

**355 Maple Avenue, Harleysville, PA 19438-2297**

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: **(215) 256-5000**

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No .

At October 31, 2006 31,485,103 shares of common stock of Harleysville Group were outstanding.

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**Item 1. Financial Statements**

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

	<u>September 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
	(Unaudited)	
<b>Assets</b>		
Investments:		
Fixed maturities:		
Held to maturity, at amortized cost (fair value \$388,724 and \$430,877)	\$ 388,120	\$ 426,579
Available for sale, at fair value (cost \$1,486,994 and \$1,235,841)	1,495,912	1,247,017
Equity securities, at fair value (cost \$62,293 and \$139,371)	66,780	179,980
Short-term investments, at cost, which approximates fair value	108,741	64,319
Fixed maturity securities on loan:		
Held to maturity, at amortized cost (fair value \$4,058 and \$7,010)	3,971	7,070
Available for sale, at fair value (amortized cost \$124,516 and \$138,718)	124,527	139,423
Total investments	<u>2,188,051</u>	<u>2,064,388</u>
Cash	142	466
Receivables:		
Premiums	144,095	141,882
Reinsurance (affiliate \$72 and \$216)	167,194	249,020
Accrued investment income	23,763	24,016
Total receivables	<u>335,052</u>	<u>414,918</u>
Deferred policy acquisition costs	104,505	104,173
Prepaid reinsurance premiums	37,345	34,256
Property and equipment, net	17,040	18,038
Deferred income taxes	67,526	63,357
Securities lending collateral	132,209	150,938
Due from affiliate	13,562	1,022
Other assets	50,198	53,710
Total assets	<u>\$ 2,945,630</u>	<u>\$ 2,905,266</u>
<b>Liabilities and Shareholders' Equity</b>		
Liabilities:		
Unpaid losses and loss settlement expenses (affiliate \$182,245 and \$187,293)	\$ 1,473,017	\$ 1,480,802
Unearned premiums (affiliate \$42,691 and \$41,618)	450,920	440,755
Accounts payable and accrued expenses	87,823	99,888
Securities lending obligation	132,209	150,938
Debt (affiliate \$18,500 and \$18,500)	118,500	118,500
Total liabilities	<u>2,262,469</u>	<u>2,290,883</u>
Shareholders' equity:		
Preferred stock, \$1 par value, authorized 1,000,000 shares; none issued		
Common stock, \$1 par value, authorized 80,000,000 shares; issued 32,830,625 and 32,008,142 shares; outstanding 31,432,716 and 30,610,233 shares	32,831	32,008
Additional paid-in capital	190,837	169,881
Accumulated other comprehensive income (loss)	(5,110)	20,288
Retained earnings	489,090	417,705
Deferred compensation		(1,012)
Treasury stock, at cost, 1,397,909 shares	(24,487)	(24,487)
Total shareholders' equity	<u>683,161</u>	<u>614,383</u>
Total liabilities and shareholders' equity	<u>\$ 2,945,630</u>	<u>\$ 2,905,266</u>

See accompanying notes to consolidated financial statements.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**  
**For the three months ended September 30, 2006 and 2005**  
(dollars in thousands, except per share data)

	<u>2006</u>	<u>2005</u>
Revenues:		
Premiums earned from affiliate (ceded to affiliate, \$186,164 and \$188,750)	\$ 210,409	\$ 212,327
Investment income, net of investment expense	26,388	23,064
Realized investment gains (losses)	138	(1)
Other income (affiliate \$1,648 and \$1,719)	<u>4,188</u>	<u>3,811</u>
Total revenues	<u>241,123</u>	<u>239,201</u>
Losses and expenses:		
Losses and loss settlement expenses (ceded to affiliate, \$127,187 and \$120,513)	133,324	139,078
Amortization of deferred policy acquisition costs	53,735	53,163
Other underwriting expenses	20,431	22,851
Interest expense (affiliate \$268 and \$177)	1,749	1,660
Other expenses	<u>1,407</u>	<u>1,036</u>
Total expenses	<u>210,646</u>	<u>217,788</u>
Income before income taxes	30,477	21,413
Income taxes	<u>8,685</u>	<u>4,972</u>
Net income	<u>\$ 21,792</u>	<u>\$ 16,441</u>
Per common share:		
Basic earnings	<u>\$ .70</u>	<u>\$ .54</u>
Diluted earnings	<u>\$ .69</u>	<u>\$ .54</u>
Cash dividend	<u>\$ .19</u>	<u>\$ .175</u>

See accompanying notes to consolidated financial statements.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**  
**For the nine months ended September 30, 2006 and 2005**  
(dollars in thousands, except per share data)

	<u>2006</u>	<u>2005</u>
Revenues:		
Premiums earned from affiliate (ceded to affiliate, \$554,397 and \$559,191)	\$ 628,074	\$ 628,872
Investment income, net of investment expense	75,330	67,403
Realized investment gains	40,420	67
Other income (affiliate \$4,963 and \$5,220)	<u>13,374</u>	<u>12,252</u>
Total revenues	<u>757,198</u>	<u>708,594</u>
Losses and expenses:		
Losses and loss settlement expenses (ceded to affiliate, \$361,463 and \$377,018)	404,362	430,943
Amortization of deferred policy acquisition costs	159,806	156,124
Other underwriting expenses	59,986	57,984
Interest expense (affiliate \$745 and \$485)	5,190	4,945
Other expenses	<u>3,762</u>	<u>4,306</u>
Total expenses	<u>633,106</u>	<u>654,302</u>
Income before income taxes and cumulative effect of accounting change	124,092	54,292
Income taxes	<u>36,862</u>	<u>11,342</u>
Income before cumulative effect of accounting change	87,230	42,950
Cumulative effect of accounting change, net of income taxes	<u>942</u>	<u>          </u>
Net income	<u>\$ 88,172</u>	<u>\$ 42,950</u>
Per common share:		
Basic income before cumulative effect of accounting change	\$ 2.83	\$ 1.42
Basic cumulative effect of accounting change	<u>.03</u>	<u>          </u>
Basic net income	<u>\$ 2.86</u>	<u>\$ 1.42</u>
Diluted income before cumulative effect of accounting change	\$ 2.78	\$ 1.41
Diluted cumulative effect of accounting change	<u>.03</u>	<u>          </u>
Diluted net income	<u>\$ 2.81</u>	<u>\$ 1.41</u>
Cash dividend	<u>\$ .54</u>	<u>\$ .515</u>

See accompanying notes to consolidated financial statements.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
**(Unaudited)**  
**For the nine months ended September 30, 2006**  
(dollars in thousands)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Retained Earnings</u>	<u>Deferred Compensation</u>	<u>Treasury Stock</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>						
Balance at December 31, 2005	32,008,142	\$ 32,008	\$ 169,881	\$ 20,288	\$ 417,705	\$ (1,012)	\$ (24,487)	\$ 614,383
Net income					88,172			88,172
Other comprehensive income, net of tax:								
Unrealized investment losses, net of reclassification adjustment				(25,398)				(25,398)
Comprehensive income								62,774
Issuance of common stock:								
Incentive plans	807,780	808	14,939					15,747
Dividend reinvestment plan	14,703	15	444					459
Tax benefit from stock compensation			3,199					3,199
Stock compensation			3,386					3,386
Reclassification of deferred compensation			(1,012)			1,012		
Cash dividend paid					(16,787)			(16,787)
Balance at September 30, 2006	<u>32,830,625</u>	<u>\$ 32,831</u>	<u>\$ 190,837</u>	<u>\$ (5,110)</u>	<u>\$ 489,090</u>	<u>\$</u>	<u>\$ (24,487)</u>	<u>\$ 683,161</u>

See accompanying notes to consolidated financial statements.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**For the nine months ended September 30, 2006 and 2005**  
(in thousands)

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Net income	\$ 88,172	\$ 42,950
Adjustments to reconcile net income		
to net cash provided by operating activities:		
Gain on sale of investments	(40,420)	(67)
Cumulative effect of accounting change, net of tax	(942)	
Change in receivables, unearned premiums and		
prepaid reinsurance balances	86,942	(25,515)
Change in affiliate balance	(12,540)	(28,383)
Increase (decrease) in unpaid losses and loss settlement expenses	(7,785)	130,803
Deferred income taxes	8,999	(724)
Increase in deferred policy acquisition costs	(332)	(5,848)
Amortization and depreciation	3,183	3,955
Other, net	(11,243)	(1,245)
Net cash provided by operating activities	<u>114,034</u>	<u>115,926</u>
Cash flows from investing activities:		
Fixed maturity investments:		
Purchases	(373,929)	(217,595)
Sales or maturities	184,051	90,343
Equity securities:		
Purchases	(63,435)	(55,873)
Sales	181,034	31,343
Net sales (purchases) of short-term investments	(44,422)	48,877
Sale (purchase) of property and equipment	(280)	1,357
Net cash used by investing activities	<u>(116,981)</u>	<u>(101,548)</u>
Cash flows from financing activities:		
Issuance of common stock	16,211	5,180
Repayment of debt obligations		(565)
Dividends paid (to affiliate, \$9,181 and \$8,756)	(16,787)	(15,650)
Excess tax benefits from share-based payment arrangements	3,199	
Net cash provided (used) by financing activities	<u>2,623</u>	<u>(11,035)</u>
Increase (decrease) in cash	(324)	3,343
Cash at beginning of period	466	328
Cash at end of period	<u>\$ 142</u>	<u>\$ 3,671</u>

See accompanying notes to consolidated financial statements.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1 - Basis of Presentation

The financial information for the interim periods included herein is unaudited; however, such information reflects all adjustments which are, in the opinion of management, necessary to a fair presentation of the financial position, results of operations, and cash flows for the interim periods. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year.

These financial statements should be read in conjunction with the financial statements and notes for the year ended December 31, 2005 included in the Company's 2005 Annual Report filed with the Securities and Exchange Commission on Form 10-K.

The affiliate transaction disclosures on the face of the financial statements are in regards to transactions with Harleysville Mutual Insurance Company (Mutual). Mutual owns approximately 54% of the outstanding common stock of Harleysville Group Inc. As used herein, "Harleysville Group" refers to Harleysville Group Inc. and its subsidiaries.

2. - Share-Based Payments

Harleysville Group has several share-based compensation plans. Harleysville Group had accounted for the plans under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no compensation expense was recognized prior to 2006 for fixed stock option grants and an employee stock purchase plan. Effective January 1, 2006, Harleysville Group adopted SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123(R)), which replaces SFAS No. 123 and supercedes APB Opinion No. 25, using the modified prospective application provisions. SFAS No. 123(R) requires that the cost resulting from all share-based payment transactions be recognized in the financial statements.

Implementing SFAS No. 123(R) did not have a material effect on income before cumulative effect of accounting change and basic or diluted earnings per share before cumulative effect of accounting change in the three or nine months ended September 30, 2006. A cumulative effect of change in accounting benefit of \$942,000, net of tax of \$507,000 was recorded in the first quarter of 2006 related to the accounting for the Long Term Incentive Plan (LTIP). The LTIP has a cash component and a stock component which awards shares based on the total shareholder return of the Company's stock relative to the total shareholder return of a group of insurance company stocks. Under APB Opinion No. 25, this plan had been accounted for using the intrinsic method. Under SFAS No. 123(R), the cash component is accounted for under the liability method and the stock component is accounted for as an equity instrument. SFAS No. 123(R) eliminated the presentation of the contra-equity account on the face of the Consolidated Balance Sheets, "Deferred Compensation." As a result, \$1,012,000 was reclassified from "Deferred Compensation" to "Additional Paid-In Capital" as of January 1, 2006.

Under SFAS No. 123(R), the compensation expense for the various share-based compensation plans that has been charged against income before income taxes and cumulative effect of accounting change was \$1,136,000 and \$3,386,000 for the three and nine months ended September 30, 2006, respectively, with a corresponding income tax benefit of \$372,000 and \$1,097,000, respectively. In accordance with APB Opinion No. 25, the compensation expense that was charged against income before tax was \$544,000 and \$42,000 for the three and nine months ended September 30, 2005, respectively, with a corresponding income tax benefit of \$190,000 and \$15,000, respectively.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
(Unaudited)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

The following table illustrates the effect on net income and earnings per share as if the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (as amended by SFAS No. 148), "Accounting for Stock-Based Compensation," had been applied for the three and nine months ended September 30, 2005:

	<b>For the three months ended September 30, 2005</b>	<b>For the nine months ended September 30, 2005</b>
	(in thousands, except per share data)	
Net income, as reported	\$ 16,441	\$ 42,950
Plus:		
Stock-based employee compensation expense included in reported net income, net of related tax effects	354	27
Less:		
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(760)	(1,607)
Pro forma net income	\$ 16,035	\$ 41,370
Basic earnings per share:		
As reported	\$ .54	\$ 1.42
Pro forma	\$ .53	\$ 1.36
Diluted earnings per share:		
As reported	\$ .54	\$ 1.41
Pro forma	\$ .52	\$ 1.36

**Fixed Stock Option Plans**

Harleysville Group has an Equity Incentive Plan (EIP) for key employees. Awards may be made in the form of stock options, stock appreciation rights (SARs), restricted stock or any combination of the above. The EIP was amended in 1997 and 2006 and limited future awards to an aggregate of 1,000,000 shares, plus the remaining shares under the 1997 plan, of Harleysville Group Inc.'s common stock. Such shares may be authorized and unissued shares or treasury shares. The plan provides that stock options may become exercisable from six months to 10 years from the date of grant with an option price not less than fair market value on the date of grant. Options granted prior to 2006 normally vest 50% at the end of one year and 50% at the end of two years from the date of grant. Options granted in 2006 normally vest 33 1/3% at the end of one year, 33 1/3% at the end of two years and 33 1/3% at the end of three years from the date of grant. SARs have not been material. Restricted stock awards have vesting periods of three to five years and vest 100% at the end of the period.

In determining the expense to be recorded for stock options, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The significant assumptions utilized in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield, and expected volatility. The risk-free interest rate is the implied yield currently available on U.S. Treasury zero-coupon issues with a remaining term equal to the expected term used as the assumption in the model. The expected term of an option award is based on historical experience of similar awards. The dividend yield is determined by dividing the per share-dividend by the grant

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
(Unaudited)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

date stock price. The expected volatility is based on the volatility of the Company's stock price over a historical period comparable to the expected term. The weighted average assumptions used in applying the Black-Scholes valuation model for the nine months ended September 30, 2006 and 2005 are shown below:

	For the nine months ended September 30,	
	2006	2005
Risk-free interest rate	4.96%	4.03%
Expected term	6 years	6 years
Dividend yield	2.38%	3.20%
Expected volatility	34.67%	36.16%

The expense to be recorded for restricted stock awards is determined utilizing the number of awards granted and the grant date fair market value.

A summary of share option activity under the plan is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2006	2,468,497	\$ 22.30		
Granted 2006	311,840	29.38		
Exercised 2006	(672,749)	21.14		
Forfeited or expired 2006	(41,139)	24.12		
Outstanding at September 30, 2006	2,066,449	\$ 23.72	6.6	\$ 23,289
Exercisable at September 30, 2006	1,540,278	\$ 22.91	4.2	\$ 18,611

The per share weighted-average fair value of options granted during the nine months ended September 30, 2006 and 2005 was \$9.70 and \$6.29, respectively. The total intrinsic value of options exercised was \$6,729,000 and \$852,000 for the nine months ended September 30, 2006 and 2005, respectively.

A summary of restricted stock activity under the plan is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Restricted stock awards at January 1, 2006	56,637	\$ 22.60
Granted 2006	92,907	28.94
Forfeited 2006	(7,307)	25.25
Restricted stock awards at September 30, 2006	142,237	\$ 26.60

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
(Unaudited)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

The Company recognized compensation expense of \$850,000 and \$2,262,000 related to share options and restricted stock awards granted under the plan for the three and nine months ended September 30, 2006, respectively. The Company recognized compensation expense (benefit) of \$57,000 and \$(8,000) for the three and nine months ended September 30, 2005, respectively. As of September 30, 2006, the Company's total unrecognized compensation cost related to nonvested share-based compensation arrangements (including share options and restricted stock awards) granted under the plan was \$4,953,000. The cost is expected to be recognized over a weighted average period of 2.8 years. No restricted stock shares vested during the nine months ended September 30, 2006 and 2005.

**Other Stock Purchase and Incentive Plans**

Harleysville Group Inc. is authorized to issue up to 1,650,000 shares of common stock under the terms of the 1995 Employee Stock Purchase Plan as amended in 2003. Such shares may be authorized and unissued shares or treasury shares. Virtually all employees are eligible to participate in the plan, under which a participant may elect to have up to 15% of base pay withheld to purchase shares. The purchase price of the stock is 85% of the lower of the beginning-of-the-subscription-period or end-of-the-subscription-period fair market value. Each subscription period runs from January 15 through July 14, or July 15 through January 14.

In determining the expense to be recorded for the employee stock purchase plan, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	<u>Employee Stock Purchase Plan</u>	
	<u>For the nine months ended</u>	
	<u>September 30,</u>	
	<u>2006</u>	<u>2005</u>
Risk-free interest rate	4.84%	3.03%
Expected term	6 months	6 months
Dividend yield	2.39%	3.05%
Expected volatility	23.33%	30.59%

The weighted-average fair value of options granted under the employee stock purchase plan was \$6.11 and \$4.90 for the nine months ended September 30, 2006 and 2005, respectively. The total intrinsic value of options exercised under the plan was \$579,000 and \$471,000 for the nine months ended September 30, 2006 and 2005, respectively. Compensation expense of \$75,000 and \$253,000 related to grants under the plan was recognized in the three and nine months ended September 30, 2006, respectively. As of September 30, 2006, there was \$97,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plan. The cost is expected to be recognized over a period of four months.

The 1996 Directors' Stock Purchase plan provided for the issuance of up to 200,000 shares of Harleysville Group Inc. common stock to outside directors of Harleysville Group Inc. and Mutual. The purchase price of the stock was 85% of the lower of the beginning-of-the-subscription-period or end-of-the-subscription-period fair market value. This plan was discontinued and the last subscription period ended January 14, 2005. For the nine months ended September 30, 2005, there were 3,887 shares issued under the plan for which \$23,000 of expense was recognized.

The 2005 Non-Employee Directors' Deferred Stock Unit Plan provides for the grant of up to 110,000 fully vested deferred stock units to outside directors of Harleysville Group Inc. and Mutual. Each stock unit represents the right to receive, without payment to the Company, one share of common stock of Harleysville Group Inc. At each April Board of Directors meeting, through the April 2009 meeting, each non-employee director shall receive a number of deferred stock units equal to the result of dividing \$30,000 by the fair market value of a share of HGI common stock.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
(Unaudited)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

The expense to be recorded for the deferred stock units is determined utilizing the number of awards granted and the grant date fair market value. The expense is recognized at the date of grant as the awards are fully vested. For the nine months ended September 30, 2006, 10,050 units were issued for which \$254,000 of expense was recognized. For the nine months ended September 30, 2005, 13,500 units were issued for which \$232,000 of expense was recognized. No units were issued and no expense was recognized for the three months ended September 30, 2006 and 2005.

The Long Term Incentive Plan (LTIP) provides for the issuance of up to 600,000 shares of Harleysville Group Inc. common stock, which may be authorized and unissued shares or treasury shares. Shares are awarded to key employees based on the total shareholder return of the Company's stock relative to the total shareholder return of a group of insurance company stocks for a three year period. Current plans are in effect for the three year period January 1, 2004 through December 31, 2006 and January 1, 2005 through December 31, 2007. The fair value of the stock component of the plan was estimated on the date of grant using a 10,000 trial simulation with the following assumptions:

	<u>Plan Years</u>	
	<u>2004-2006</u>	<u>2005-2007</u>
Risk-free interest rate	2.16%	3.63%
Expected volatility	42.6%	37.2%
Target number of shares to be issued	58,481	69,638

The weighted-average grant date fair value of the 2004-2006 plan and 2005-2007 plan awards was \$19.65 and \$19.64, respectively. Compensation expense of \$210,000 and \$612,000 was recognized related to the stock component of the LTIP for the three and nine months ended September 2006, respectively. Compensation expense of \$448,000 was recognized for the three months ended September 30, 2005 and a compensation benefit of \$52,000 was recognized for the nine months ended September 30, 2005 related to the stock component of the LTIP. As of September 30, 2006, there was \$666,000 of unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the LTIP. This cost is expected to be recognized over a period of 1.25 years. No shares were issued under the plan in the nine months ended September 30, 2006 and 2005.

The LTIP also has a cash component. This component had been accounted for under the intrinsic method of APB Opinion No. 25. Effective January 1, 2006, it is now being accounted for under the liability method of SFAS No. 123(R). Compensation expense of \$227,000 and \$480,000 was recognized related to the cash component of the LTIP for the three and nine months ended September 30, 2006, respectively. Compensation expense of \$158,000 was recognized for the three months ended September 30, 2005 and a compensation benefit of \$50,000 was recognized for the nine months ended September 30, 2005 related to the cash component of the LTIP. As of September 30, 2006, there was \$287,000 of unrecognized compensation cost related to the cash component. This cost is expected to be recognized over a period of 1.25 years.

Cash received from option exercises under all share-based payment arrangements for the nine months ended September 30, 2006 and 2005 was \$14,540,000 and \$3,609,000, respectively. The actual tax benefit realized for the tax deductions from option exercises of the share-based payment arrangements was \$2,355,000 and \$298,000, respectively, for the nine months ended September 2006 and 2005.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
(Unaudited)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

3 - Earnings Per Share

The computation of basic and diluted earnings per share is as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	2005	2006	2005
	(in thousands, except per share data)			
Numerator for basic and diluted earnings per share:				
Net income	\$ 21,792	\$ 16,441	\$ 88,172	\$ 42,950
Denominator for basic earnings per share -- weighted average shares outstanding	31,116	30,428	30,864	30,330
Effect of stock incentive plans	598	161	459	156
Denominator for diluted earnings per share	31,714	30,589	31,323	30,486
Basic earnings per share	\$ .70	\$ .54	\$ 2.86	\$ 1.42
Diluted earnings per share	\$ .69	\$ .54	\$ 2.81	\$ 1.41

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

	For the three months ended September 30,	For the nine months ended September 30,
	2005	2005
	(in thousands)	
Number of options	1,184	1,184

4 – Reinsurance

Premiums earned are net of amounts ceded of \$21,763,000 and \$62,066,000 for the three and nine months ended September 30, 2006, respectively, and \$24,711,000 and \$70,538,000 for the three and nine months ended September 30, 2005, respectively. Losses and loss settlement expenses are net of amounts ceded of \$12,136,000 and \$26,529,000 for the three and nine months ended September 30, 2006, respectively, and \$71,856,000 and \$83,052,000 for the three and nine months ended September 30, 2005, respectively. Losses and loss settlement expenses ceded for the three and nine months ended September 30, 2005 include \$67,566,000 and \$74,866,000 of losses ceded to the federal government's National Flood Insurance Program (NFIP), primarily related to flood losses from Hurricane Katrina. Since such flood losses are entirely ceded to the NFIP they did not impact results of operations. Such amounts ceded do not include the reinsurance transactions with Mutual under the pooling arrangement (described below) which are reflected on the face of the income statements, but do include reinsurance with unaffiliated reinsurers and the reinsurance described in the following paragraph.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

Harleysville Group had a reinsurance agreement with Mutual whereby Mutual reinsured accumulated catastrophe losses in a quarter up to \$14,400,000 in excess of \$3,600,000 in return for a reinsurance premium. The agreement was terminated on December 31, 2005. The agreement excluded catastrophe losses resulting from earthquakes, terrorism or hurricanes, and supplemented the existing external catastrophe reinsurance program. Under the agreement, Harleysville Group ceded to Mutual no premiums earned for the three and nine months ended September 30, 2006 and premiums earned of \$2,196,000 and \$6,607,000 for the three and nine months ended September 30, 2005, respectively. Losses incurred ceded to Mutual under the agreement were not material in either period of 2006 and 2005.

Pursuant to the terms of a reinsurance pooling agreement with Mutual, each of the insurance subsidiaries of Harleysville Group Inc. cedes premiums, losses and expenses on all of their respective business to Mutual which, in turn, retrocedes to such subsidiaries a specified portion of premiums, losses and expenses of Mutual and such subsidiaries. Because this agreement does not relieve Harleysville Group Inc.'s insurance subsidiaries of primary liability as originating insurers, there is a concentration of credit risk arising from business ceded to Mutual. However, the reinsurance pooling agreement provides for the right of offset. Mutual has an A. M. Best rating of "A-" (Excellent).

5 - Cash Flows

Net cash tax payments of \$25,750,000 and \$8,600,000 were made in the first nine months of 2006 and 2005, respectively. Cash interest payments of \$6,491,000 and \$6,245,000 were made in the first nine months of 2006 and 2005, respectively.

6 - Segment Information

The performance of the personal lines and commercial lines is evaluated based upon underwriting results as determined under statutory accounting practices (SAP).

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
(Unaudited)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

Financial data by segment is as follows:

	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b><u>2006</u></b>	<b><u>2005</u></b>	<b><u>2006</u></b>	<b><u>2005</u></b>
	(in thousands)			
<b>Revenues:</b>				
Premiums earned				
Commercial lines	\$ 173,941	\$ 173,948	\$ 518,753	\$ 512,119
Personal lines	<u>36,468</u>	<u>38,379</u>	<u>109,321</u>	<u>116,753</u>
Total premiums earned	210,409	212,327	628,074	628,872
Net investment income	26,388	23,064	75,330	67,403
Realized investment gains (losses)	138	(1)	40,420	67
Other	<u>4,188</u>	<u>3,811</u>	<u>13,374</u>	<u>12,252</u>
<b>Total revenues</b>	<b><u>\$ 241,123</u></b>	<b><u>\$ 239,201</u></b>	<b><u>\$ 757,198</u></b>	<b><u>\$ 708,594</u></b>
<b>Income before income taxes and cumulative effect of accounting change:</b>				
Underwriting gain (loss):				
Commercial lines	\$ 2,793	\$ (5,742)	\$ (4,743)	\$ (25,740)
Personal lines	<u>1,540</u>	<u>2,497</u>	<u>9,799</u>	<u>4,028</u>
SAP underwriting gain (loss)	4,333	(3,245)	5,056	(21,712)
GAAP adjustments	<u>(1,414)</u>	<u>480</u>	<u>(1,136)</u>	<u>5,533</u>
GAAP underwriting gain (loss)	2,919	(2,765)	3,920	(16,179)
Net investment income	26,388	23,064	75,330	67,403
Realized investment gains (losses)	138	(1)	40,420	67
Other	<u>1,032</u>	<u>1,115</u>	<u>4,422</u>	<u>3,001</u>
<b>Income before income taxes and cumulative effect of accounting change</b>	<b><u>\$ 30,477</u></b>	<b><u>\$ 21,413</u></b>	<b><u>\$ 124,092</u></b>	<b><u>\$ 54,292</u></b>

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
(Unaudited)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

7 - Comprehensive Income

Comprehensive income for the three and nine months ended September 30, 2006 and 2005 consisted of the following (all amounts are net of taxes):

	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(in thousands)			
Net income	\$ 21,792	\$ 16,441	\$ 88,172	\$ 42,950
Other comprehensive income (loss):				
Unrealized investment holding gains (losses) arising during period	21,042	(11,363)	857	(17,170)
Less:				
Reclassification adjustment for gains included in net income	(72)		(26,255)	(44)
Net unrealized investment gains (losses)	<u>20,970</u>	<u>(11,363)</u>	<u>(25,398)</u>	<u>(17,214)</u>
Comprehensive income	<u>\$ 42,762</u>	<u>\$ 5,078</u>	<u>\$ 62,774</u>	<u>\$ 25,736</u>

8 - Pension

Harleysville Group Inc. has a pension plan that covers substantially all full-time employees. The plan was frozen at the then current benefit levels as of March 31, 2006, at which time the accrual of future benefits for eligible employees ceased. A curtailment benefit for the supplemental executive retirement plan of \$146,000 was recognized in the first quarter of 2006. The net periodic pension cost for the plan including Mutual consists of the following components:

	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(in thousands)			
Components of net periodic pension cost:				
Service cost	\$ (7)	\$ 2,315	\$ 2,365	\$ 6,733
Interest cost	2,685	2,986	7,879	8,962
Expected return on plan assets	(2,943)	(3,018)	(8,755)	(8,598)
Recognized net actuarial loss	555	1,134	1,373	3,358
Amortization of prior service cost		52	5	156
Net transition amortization		13	13	40
Curtailment gain			(222)	
Net periodic pension cost:				
Entire plan	<u>\$ 290</u>	<u>\$ 3,482</u>	<u>\$ 2,658</u>	<u>\$ 10,651</u>
Harleysville Group portion	<u>\$ 191</u>	<u>\$ 2,308</u>	<u>\$ 1,749</u>	<u>\$ 7,057</u>

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

Harleysville Group's expected portion of the 2006 contribution to the pension plan is \$2,076,000. Contributions of \$1,548,000 were made in the nine months ended September 30, 2006.

9 – Shareholders' Equity

Various states have adopted the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) standards that require insurance companies to calculate and report statutory capital and surplus needs based on a formula measuring underwriting, investment and other business risks inherent in an individual company's operations. These RBC standards have not affected the operations of Harleysville Group since each of the Company's insurance subsidiaries has statutory capital and surplus in excess of RBC requirements.

These RBC standards require the calculation of a ratio of total adjusted capital to Authorized Control Level. Insurers with a ratio below 200% are subject to different levels of regulatory intervention and action. Based upon their 2005 statutory financial statements, the ratio of total adjusted capital to the Authorized Control Level for the Company's nine insurance subsidiaries at December 31, 2005 ranged from 495% to 606%.

10 – Impact of New Accounting Standards

In February 2006, the Financial Accounting Standards Board issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140." This accounting standard permits fair value remeasurement for any hybrid financial instrument containing an embedded derivative that otherwise would require bifurcation; clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133; establishes a requirement to evaluate interests in securitized financial assets to identify them as freestanding derivatives or as hybrid financial instruments containing an embedded derivative requiring bifurcation; clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument pertaining to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year beginning after September 15, 2006. The impact of adopting this statement is currently being evaluated.

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109." This Interpretation clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." This Interpretation is effective for fiscal years beginning after December 15, 2006. The impact of adopting this Interpretation is currently being evaluated.

In September 2006, the Financial Accounting Standards Board issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)." This statement requires an employer to recognize the overfunded or underfunded status of a single-employer defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through comprehensive income. An employer with publicly traded equity securities is required to initially recognize the funded status of defined benefit post-retirement plans and provide required disclosures as of the end of the fiscal year ending after December 15, 2006. The impact of adopting this statement is currently being evaluated.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108 to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that registrants quantify the impact on the current year's financial statements of correcting all misstatements, including the carryover and reversing effects of prior years' misstatements, as well as the effects of errors arising in the current year. SAB 108 is effective as of the first fiscal year ending after November 15, 2006, allowing a one-time transitional cumulative effect adjustment to retained earnings as of January 1, 2006, for errors that were not previously deemed material, but are material under the guidance in SAB No. 108. The impact of adopting SAB No. 108 is currently being evaluated.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Certain of the statements contained herein (other than statements of historical facts) are forward looking statements. Such forward looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and include estimates and assumptions related to economic, competitive and legislative developments. These forward looking statements are subject to change and uncertainty which are, in many instances, beyond the Company's control and have been made based upon management's expectations and beliefs concerning future developments and their potential effect on Harleysville Group. There can be no assurance that future developments will be in accordance with management's expectations so that the effect of future developments on Harleysville Group will be those anticipated by management. Actual financial results, including premium growth and underwriting results, could differ materially from those anticipated by Harleysville Group depending on the outcome of certain factors, which may include changes in property and casualty loss trends and reserves; catastrophe losses; competition in insurance product pricing; government regulation and changes therein which may impede the ability to charge adequate rates; performance of the financial markets; fluctuations in interest rates; availability and price of reinsurance; the A. M. Best rating of Harleysville Group; and the status of labor markets in which the Company operates.

## Overview

The Company's net income is primarily determined by three elements:

- net premium income
- investment income including realized investment gains
- amounts paid or reserved to settle insured claims

A number of factors may affect the level of premium income, including:

- limitations on rates arising from the competitive market place or regulation
- limitation on available business arising from a need to maintain the quality of underwritten risks
- the Company's ability to maintain its A- ("excellent") rating by A.M. Best
- the ability of the Company to maintain a reputation for efficiency and fairness in claims administration

A number of factors may affect the level of investment income, including:

- general interest rate levels and amounts of cash flow
- specific adverse events affecting the issuers of debt obligations held by the Company
- changes in the prices of equity securities generally and those held by the Company specifically

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Management's Discussion and Analysis of Financial Condition  
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(Continued)

Loss and loss settlement expenses are affected by a number of factors, including:

- the quality of the risks underwritten by the Company
- the nature and severity of catastrophe losses
- the availability, cost and terms of reinsurance
- underlying settlement costs, including medical and legal costs

The Company seeks to manage each of the foregoing to the extent within its control. Many of the foregoing factors are partially, or entirely, outside of the control of the Company.

**Critical Accounting Policies and Estimates**

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles, which require Harleysville Group to make estimates and assumptions (see Note 1 of the Notes to Consolidated Financial Statements for the year ended December 31, 2005 included in the Company's 2005 Annual Report filed with the Securities and Exchange Commission on Form 10-K). Harleysville Group believes that of its significant accounting policies, the following may involve a higher degree of judgment and estimation. The judgments, or the methodology on which the judgments are made, are reviewed quarterly with the Audit Committee.

**Liability for Losses and Loss Settlement Expenses.** The liability for losses and loss settlement expenses represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims which have not yet been reported to Harleysville Group. The amount of loss reserves for reported claims is based 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 amounts of loss reserves for unreported claims and loss settlement expense reserves are determined utilizing historical information by line of insurance as adjusted to current conditions. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results. Reserves are closely monitored and are recomputed periodically using the most recent information on reported claims and a variety of statistical techniques. It is expected that such estimates will be more or less than the amounts ultimately paid when the claims are settled. Changes in these estimates are reflected in current operations.

**Investments.** Generally, unrealized investment gains or losses on investments carried at fair value, net of applicable income taxes, are reflected directly in shareholders' equity as a component of comprehensive income and, accordingly, have no effect on net income. However, if the fair value of an investment declines below its cost and that decline is deemed other than temporary, the amount of the decline below cost is charged to earnings. Harleysville Group monitors its investment portfolio and quarterly reviews investments that have experienced a decline in fair value below cost to evaluate whether the decline is other than temporary. Such evaluations consider, among other things, the magnitude and reasons for a decline and the prospects for the fair value to recover in the near term. Future adverse investment market conditions, or poor operating results of underlying investments, could result in an impairment charge in the future.

Harleysville Group has written down to fair value, any equity security that has declined below cost by more than 20% and maintained such decline for six months, or by 50% or more, in the quarter in which either such decline occurred. In some cases, securities that have declined by a lesser amount or for a shorter period of time are written

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Management's Discussion and Analysis of Financial Condition  
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(Continued)

down if the evaluation indicates the decline is other-than-temporary. Fair value of equity securities is based on the closing market value. The fair value of mutual fund holdings is based on the closing net asset value reported by the fund. Fair value of fixed maturities is based upon data supplied by an independent pricing service. It can be difficult to determine the fair value of non-traded securities but Harleysville Group does not own a material amount of non-traded securities.

**Policy Acquisition Costs.** Policy acquisition costs, such as commissions, premium taxes and certain other underwriting and agency expenses that vary with and are primarily related to the production of business, are deferred and amortized over the effective period of the related insurance policies and in proportion to the premiums earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. The estimation of net realizable value takes into account the premium to be earned, related investment income over the claim paying period, losses and loss settlement expenses, and certain other costs expected to be incurred as the premium is earned. Future changes in estimates, the most significant of which is expected losses and loss settlement expenses, may require adjustments to deferred policy acquisition costs. If the estimation of net realizable value indicates that the acquisition costs are unrecoverable, further analyses are completed to determine if a reserve is required to provide for losses that may exceed the related unearned premiums.

**Contingencies.** Besides claims related to its insurance products, Harleysville Group is subject to proceedings, lawsuits and claims in the normal course of business. Harleysville Group assesses the likelihood of any adverse outcomes to these matters as well as potential ranges of probable losses. There can be no assurance that actual outcomes will not differ from those assessments.

The application of certain of these critical accounting policies to the periods ended September 30, 2006 and 2005 is discussed in greater detail below.

**Results of Operations**

Premiums earned decreased \$1.9 million and \$0.8 million during the three and nine months ended September 30, 2006, respectively, compared to the same prior year periods. The decrease in premiums earned for the three month period is primarily due to a decrease in premiums earned for personal lines of \$1.9 million. The decrease in premiums earned for the nine month period is primarily due to a decrease of \$7.4 million in premiums earned for personal lines, partially offset by an increase of \$6.6 million in premiums earned for commercial lines. The change in premiums earned for commercial lines was 0% and 1.3% for the three and nine months ended September 30, 2006, respectively. The increase in the nine month period is primarily due to higher average premiums. The declines in premiums earned for personal lines were 5.0% and 6.4% for the three and nine months ended September 30, 2006, respectively, primarily due to fewer policy counts. The reduction in personal lines volume was driven primarily by a reduction of personal automobile business from the continued implementation of more stringent underwriting processes.

Investment income increased \$3.3 million and \$7.9 million for the three and nine months ended September 30, 2006, respectively, compared to the same prior year periods, primarily due to a higher level of invested assets, a greater percentage of invested assets in fixed maturity securities and higher interest rates on short-term investments.

Realized investment gains increased \$40.4 million for the nine months ended September 30, 2006, as compared to the same period in the prior year, and were essentially unchanged for the three months ended September 30, 2006. The nine-month increase primarily resulted from gains on the sale of equity securities in the second quarter of 2006.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management's Discussion and Analysis of Financial Condition  
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Harleysville Group holds securities with unrealized losses at September 30, 2006 as follows:

	<u>Fair Value</u>	<u>Unrealized Loss</u> (in thousands)	<u>Length of Unrealized Loss</u>	
			<u>Less Than 12 Months</u>	<u>Over 12 Months</u>
Fixed maturities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 155,918	\$ 2,631	\$ 334	\$ 2,297
Obligations of states and political subdivisions	182,924	3,958	468	3,490
Corporate securities	280,529	6,797	738	6,059
Mortgage-backed securities	<u>161,020</u>	<u>2,607</u>	<u>885</u>	<u>1,722</u>
Total fixed maturities	<u>\$ 780,391</u>	<u>\$ 15,993</u>	<u>\$ 2,425</u>	<u>\$ 13,568</u>
Equity securities	<u>\$ 3,187</u>	<u>\$ 17</u>	<u>\$ 15</u>	<u>\$ 2</u>

Of the total fixed maturity securities with an unrealized loss at September 30, 2006, securities with a fair value of \$622.1 million and an unrealized loss of \$11.9 million are classified as available for sale and are carried at fair value on the balance sheet while securities with a fair value of \$158.3 million and an unrealized loss of \$4.1 million are classified as held to maturity on the balance sheet and are carried at amortized cost.

The fixed maturity investments with continuous unrealized losses for less than twelve months were primarily due to the impact of the higher market interest rates rather than a decline in credit quality. There are \$518.3 million in fixed maturity securities, at fair value, that at September 30, 2006, had been below amortized cost for over twelve months. Of the \$13.6 million of unrealized losses on such securities, \$13.4 million primarily relates to securities which carry investment grade ratings and have declined in fair value roughly in line with market interest rate changes. The remaining \$0.2 million of unrealized losses are comprised of airline enhanced equipment trust certificates (EETC) as follows:

	<u>Cost</u>	<u>Fair Value</u> (in thousands)	<u>Maturity Date</u>
American Airlines	<u>\$ 14,374</u>	<u>\$ 14,166</u>	2011

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Management's Discussion and Analysis of Financial Condition  
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The EETCs are all "A tranche" holdings, which means they are in a senior credit position to the underlying airplane collateral value as compared to B and C tranche holders. The investment in these securities generally took place between January 2000 and August 2001. The fair value of the EETCs reflects the market price of the securities provided by our custodian bank, the Bank of New York, through an unaffiliated third party pricing service. The fair value of the EETCs has increased since 2001, when the fair value first went below cost. Harleysville Group currently has the ability and intent to continue to maintain its holdings in the EETC investments until maturity. It is possible that the EETCs may be written down in the income statement in the future, depending upon, among other things, developments involving both the issuers and world events which impact the level of air travel.

There are three positions that comprise the unrealized loss in equity investments at September 30, 2006. They have not been below cost for significant continuous amounts of time. Harleysville Group has been monitoring these securities and it is possible that some may be written down in the income statement in the future.

Income before income taxes increased \$9.1 million for the three months ended September 30, 2006, compared to the same prior year period. The increase was primarily due to the increase in investment income and improved underwriting results. Income before income taxes and cumulative effect of accounting change increased \$69.8 million for the nine months ended September 30, 2006 compared to the same prior year period. The increase was primarily due to the increase in investment income, increased realized investment gains and improved underwriting results. The improved underwriting results in the three months ended September 30, 2006, compared to the prior year, were due to improved underwriting results in commercial lines and lower underwriting expenses, partially offset by a lower underwriting gain in personal lines and greater catastrophe losses. The improved underwriting results in the nine months ended September 30, 2006, compared to the prior year, were due to improved underwriting results in both commercial and personal lines, partially offset by greater catastrophe losses and higher underwriting expenses. Catastrophe losses were \$4.0 million and \$11.1 million for the three and nine months ended September 30, 2006, respectively, as compared to \$2.4 million and \$4.0 million for the three and nine months ended September 30, 2005, respectively. The decrease in underwriting expenses, including the amortization of deferred acquisition costs, for the three months ended September 30, 2006, compared to the prior year, is primarily due to lower pension expense and severance charges, partially offset by higher incentive costs for agents and employees, and higher compensation expenses recognized under SFAS No. 123(R), which was adopted as of January 1, 2006 as described in Note 2 to the Consolidated Financial Statements. The increase in underwriting expenses, including the amortization of deferred acquisition costs, for the nine months ended September 30, 2006, compared to the prior year, is primarily due to higher incentive costs for agents and employees and higher compensation expenses recognized under SFAS No. 123(R), partially offset by lower pension expense and severance charges.

An insurance company's statutory combined ratio is a standard measure of underwriting profitability. This ratio is the sum of (1) the ratio of incurred losses and loss settlement expenses to net earned premium, (2) the ratio of expenses incurred for commissions, premium taxes, administrative and other underwriting expenses to net written premium, and (3) the ratio of dividends to policyholders to net earned premium. The statutory combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. A ratio of less than 100 percent generally indicates underwriting profitability. Harleysville Group's statutory combined ratio decreased to 98.5% and 98.8% for the three and nine months ended September 30, 2006, respectively from 102.5% and 102.8% for the three and nine months ended September 30, 2005, respectively. The decrease in the combined ratio for the three months ended September 30, 2006 compared to the prior year is due to improved underwriting results in commercial lines, partially offset by a lower underwriting gain in personal lines. The decrease for the nine months ended September 30, 2006 compared to the prior year is due to improved underwriting results in both commercial lines and personal lines.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management's Discussion and Analysis of Financial Condition  
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The statutory combined ratios by line of business for the three and nine months ended September 30, 2006, as compared to the three and nine months ended September 30, 2005, were as follows:

	<b>For the three months ended September 30,</b>		<b>For the nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Commercial:				
Automobile	100.2%	104.5%	99.5%	100.8%
Workers compensation	116.1%	118.6%	117.3%	122.6%
Commercial multi-peril	98.3%	101.0%	99.8%	102.0%
Other commercial	80.8%	102.5%	83.3%	95.9%
Total commercial	99.5%	104.7%	100.4%	103.9%
Personal:				
Automobile	99.5%	98.1%	99.9%	102.8%
Homeowners	90.3%	88.8%	83.5%	94.5%
Other personal	65.4%	67.5%	68.0%	73.1%
Total personal	93.6%	92.8%	91.2%	97.9%
Total personal and commercial	98.5%	102.5%	98.8%	102.8%

The commercial lines statutory combined ratio decreased to 99.5% and 100.4% for the three and nine months ended September 30, 2006 from 104.7% and 103.9% for the three and nine months ended September 30, 2005. The decreases were primarily due to declines in the combined ratio for all lines of business due to improved loss severity.

The personal lines statutory combined ratio increased to 93.6% from 92.8% for the three months ended September 30, 2006 and 2005, respectively, primarily due to higher catastrophe losses which impacted the homeowners line of business. The personal lines statutory combined ratio decreased to 91.2% from 97.9% for the nine months ended September 30, 2006 and 2005, respectively, primarily due to improved property results in the homeowners line and lower loss severity in personal auto, partially offset by higher catastrophe losses.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management's Discussion and Analysis of Financial Condition  
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The following table presents the liability for unpaid losses and loss settlement expenses by major line of business:

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	(in thousands)	
Commercial:		
Automobile	\$ 304,532	\$ 282,521
Workers compensation	323,184	310,609
Commercial multi-peril	470,093	432,314
Other commercial	<u>87,163</u>	<u>80,204</u>
Total commercial	<u>1,184,972</u>	<u>1,105,648</u>
Personal:		
Automobile	91,588	95,707
Homeowners	31,630	34,465
Other personal	<u>1,382</u>	<u>1,270</u>
Total personal	<u>124,600</u>	<u>131,442</u>
Total personal and commercial	1,309,572	1,237,090
Plus reinsurance recoverables	<u>163,445</u>	<u>243,712</u>
Total liability	<u>\$ 1,473,017</u>	<u>\$ 1,480,802</u>

The following table presents the increase (decrease) in the liability for unpaid losses and loss settlement expenses attributable to insured events of prior years for the nine months ended September 30, 2006 by line of business:

	<b>Accident Years</b>			
	<b>Total</b>	<b>2005</b>	<b>2004</b>	<b>2003 and Prior Years</b>
	(in thousands)			
Commercial:				
Automobile	\$ (2,971)	\$ 1,577	\$ (5,306)	\$ 758
Workers compensation	(23)	(2,397)	(3,175)	5,549
Commercial multi-peril	(2,895)	(6,267)	(3,784)	7,156
Other commercial	<u>(489)</u>	<u>(629)</u>	<u>(1,073)</u>	<u>1,213</u>
Total commercial	<u>(6,378)</u>	<u>(7,716)</u>	<u>(13,338)</u>	<u>14,676</u>
Personal:				
Automobile	(4,453)	(1,141)	(1,702)	(1,610)
Homeowners	(4,627)	(433)	(1,466)	(2,728)
Other personal	<u>408</u>	<u>(35)</u>	<u>153</u>	<u>290</u>
Total personal	<u>(8,672)</u>	<u>(1,609)</u>	<u>(3,015)</u>	<u>(4,048)</u>
Total net development	<u>\$ (15,050)</u>	<u>\$ (9,325)</u>	<u>\$ (16,353)</u>	<u>\$ 10,628</u>

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management's Discussion and Analysis of Financial Condition  
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(Continued)

There was \$15.1 million of net favorable development in the provision for insured events in prior years for the nine months ended September 30, 2006 (\$6.1 million in the third quarter of 2006) of which \$6.4 million was in commercial lines and \$8.7 million was in personal lines. The favorable development primarily related to the 2003 through 2005 accident years as a result of lower than expected claims severity in casualty lines, partially offset by adverse development in prior accident years. The adverse development in the workers compensation line in 2003 and Prior Years primarily relates to higher than expected medical severity trends in the 1997-2001 accident years. The adverse development in the commercial multi-peril line in 2003 and Prior Years primarily relates to higher than expected claims severity in the liability portion of the line. This development was related to both the loss (\$4.4 million) and loss settlement expenses (\$2.8 million).

There was \$11.7 million of net favorable development in the provision for insured events in prior years for the nine months ended September 30, 2005 (\$2.9 million in the third quarter of 2005) of which \$5.6 million was in commercial lines and \$6.1 million was in personal lines. Approximately \$4.4 million of the \$11.7 million of favorable development related to the liability for unpaid loss settlement expenses. The remaining favorable development primarily related to the 2004 and 2003 accident years partially offset by adverse development in the prior accident years.

The following table presents workers compensation claim count information for the total pooled business in which Harleysville Group participates and payment amounts which are Harleysville Group's pooling share of the total pooled amounts:

	<u>For the nine months ended September 30, 2006</u>	<u>For the year ended December 31, 2005</u>
	(dollars in thousands)	
Number of claims pending, beginning of period	6,020	6,832
Number of claims reported	6,656	9,372
Number of claims settled or dismissed	<u>(6,833)</u>	<u>(10,184)</u>
Number of claims pending, end of period	<u>5,843</u>	<u>6,020</u>
Losses paid	\$ 41,295	\$ 66,486
Loss settlement expenses paid	\$ 9,603	\$ 14,045

Workers compensation losses primarily consist of indemnity and medical costs for injured workers. The reduction in claim counts reflects the impact of a reduction in workers compensation exposure as policy counts have declined.

Harleysville Group records the actuarial best estimate of the ultimate unpaid losses and loss settlement expenses incurred. Actuarial loss reserving techniques and assumptions, which rely on historical information as adjusted to reflect current conditions, have been consistently applied, after including consideration of recent case reserve activity, during the periods presented. Changes in the estimate of the liability for unpaid losses and loss settlement expenses reflect actual payments and evaluations of new information and data since the last reporting date. These changes correlate with actuarial trends.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

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The following table presents the liability for unpaid losses and loss settlement expenses by case and incurred but not reported (IBNR) reserves by line of business as of September 30, 2006:

	<u>Case</u>	<u>IBNR</u>	<u>LAE Liability</u> (in thousands)	<u>IBNR (Incl. LAE)</u>	<u>Total Liability</u>
Commercial:					
Automobile	\$ 108,483	\$ 147,243	\$ 48,806	\$ 196,049	\$ 304,532
Workers compensation	155,220	126,932	41,031	167,963	323,183
Commercial multi-peril	123,620	223,037	123,437	346,474	470,094
Other commercial	15,763	50,159	21,241	71,400	87,163
Total commercial	<u>403,086</u>	<u>547,371</u>	<u>234,515</u>	<u>781,886</u>	<u>1,184,972</u>
Personal:					
Automobile	44,517	30,622	16,448	47,070	91,587
Homeowners	9,902	15,475	6,254	21,729	31,631
Other personal	393	800	189	989	1,382
Total personal	<u>54,812</u>	<u>46,897</u>	<u>22,891</u>	<u>69,788</u>	<u>124,600</u>
Total net liability	<u>457,898</u>	<u>594,268</u>	<u>257,406</u>	<u>851,674</u>	<u>1,309,572</u>
Reinsurance recoverables	<u>141,354</u>	<u>20,878</u>	<u>1,213</u>	<u>22,091</u>	<u>163,445</u>
Total gross liability	<u>\$ 599,252</u>	<u>\$ 615,146</u>	<u>\$ 258,619</u>	<u>\$ 873,765</u>	<u>\$ 1,473,017</u>

Reinsurance receivables were \$167.2 million and \$249.0 million at September 30, 2006 and December 31, 2005, respectively. Of these amounts, \$103.1 million and \$183.9 million, or 62% and 74%, respectively, of the receivables were due from governmental bodies, regulatory agencies or quasi governmental pools and reinsurance facilities where, Harleysville Group believes, there is virtually no credit risk. The remainder of the reinsurance receivables are principally due from reinsurers rated A- or higher by A.M. Best. The decrease in the reinsurance receivables is primarily the result of a decrease of \$75.8 million in the amount due from the National Flood Insurance Program primarily as a result of settling claims arising from Hurricane Katrina.

Because of the nature of insurance claims, there are uncertainties inherent in the estimates of ultimate losses. Reorganization of the claims operation in recent years has resulted in new people and processes involved in settling claims. As a result, more recent statistical data reflects different patterns than in the past and gives rise to uncertainty as to the pattern of future loss settlements. There are uncertainties regarding future loss cost trends particularly related to medical treatments and automobile repair. Court decisions, regulatory changes and economic conditions can affect the ultimate cost of claims that occurred in the past. Accordingly, the ultimate liability for unpaid losses and loss settlement expenses will likely differ from the amount recorded at September 30, 2006.

The property and casualty industry has had substantial aggregate loss experience from claims related to asbestos-related illnesses, environmental remediation, product liability, mold, and other uncertain exposures. Harleysville Group has not experienced significant losses from such claims.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management's Discussion and Analysis of Financial Condition  
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Net catastrophe losses increased \$1.6 million and \$7.0 million for the three and nine months ended September 30, 2006, respectively, primarily due to more severe catastrophes in the 2006 periods.

Harleysville Group and Mutual terminated the reinsurance agreement whereby Mutual reinsured certain accumulated catastrophe losses, as described in Note 4 of Notes to Consolidated Financial Statements, as of December 31, 2005. Harleysville Group ceded to Mutual no premiums earned for the three and nine months ended September 30, 2006 and premiums earned of \$2.2 million and \$6.6 million for the three and nine months ended September 30, 2005, respectively. Losses incurred ceded to Mutual under the agreement were not material in either period of 2006 and 2005.

Effective for one year from July 1, 2006, the Company's subsidiaries and Mutual and its wholly-owned subsidiaries renewed its catastrophe reinsurance under which they are purchasing higher coverage limits while increasing their retention levels and co-participation, which will result in increased exposure for the Company's subsidiaries and Mutual to significant catastrophes as compared to the exposure under the treaty that expired on June 30, 2006. These coverage changes are being made as a result of changes in the market for catastrophe reinsurance and new catastrophe models that produce greater estimates of hurricane severity in the northeastern United States for the covered period. Annual retentions and limits on the expiring and new treaties are set forth below:

NEW PROGRAM FOR 2006-2007	EXPIRING PROGRAM FOR 2005-2006
<u>Retention:</u> \$40 million	<u>Retention:</u> \$30 million
<u>Coverage for Losses</u>	<u>Coverage for Losses</u>
65% of losses between \$40 and \$60 million	85% of losses between \$30 and \$60 million
70% of losses between \$60 and \$100 million	90% of losses between \$60 and \$100 million
85% of losses between \$100 and \$200 million	100% of losses between \$100 and \$200 million
50% of losses between \$200 and \$235 million	100% of losses between \$200 and \$235 million
20% of losses between \$235 and \$285 million	N/A

The maximum recovery under the new treaty is \$153.5 million; under the expiring treaty it was \$196.5 million. Harleysville Group's pooling share of this maximum recovery would be \$110.5 million, compared to a maximum recovery of \$141.5 million under the expiring treaty. Both the new treaty and the expiring treaty include reinstatement provisions providing for coverage for a second catastrophe and requiring payment of additional premium in the event a first catastrophe occurs. The net ceded premium for the new treaty will be approximately \$4.6 million more than the net ceded premium for the expiring treaty. Harleysville Group's pooling share of this increased premium will be approximately \$3.3 million.

Severance charges of \$0.2 million and \$1.1 million for the three and nine months ended September 30, 2006, respectively, and \$1.6 million and \$3.0 million for the three and nine months ended September 30, 2005, respectively, were incurred related to ongoing expense-reduction initiatives.

Harleysville Group froze its defined benefit pension plan at the then current benefit levels as of March 31, 2006. Harleysville Group's portion of pension expense for the plan was \$0.2 million and \$1.7 million for the three and nine months ended September 30, 2006, respectively, and \$2.3 million and \$7.1 million for the three and nine months ended September 30, 2005, respectively. Harleysville Group enhanced its 401(k) retirement savings plan to provide for a company contribution equal to 5% of salary for all eligible employees, effective April 1, 2006, and recognized expense of \$1.0 million and \$2.0 million for the three and nine months ended September 30, 2006, respectively, due to this enhancement.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Management's Discussion and Analysis of Financial Condition  
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Other income increased \$1.1 million for the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005 primarily due to an increase of \$1.9 million in claim handling fees received in connection with the National Flood Insurance Program, related primarily to flood claims from Hurricane Katrina. Other income did not change materially for the three months ended September 30, 2006 as compared to the same prior year period.

The income tax expense for the three and nine months ended September 30, 2006 includes a tax benefit of \$2.0 million and \$6.7 million associated with tax-exempt interest compared to \$2.5 million and \$7.7 million in the same prior year periods.

**Liquidity and Capital Resources**

Operating activities provided \$114.0 million and \$115.9 million of net cash for the nine months ended September 30, 2006 and 2005, respectively. The change primarily is from higher federal income tax payments, partially offset by lower paid losses and greater investment income.

Investing activities used \$117.0 million and \$101.5 million of net cash for the nine months ended September 30, 2006 and 2005, respectively. The increase is primarily due to an increase in net purchases of short-term investments and fixed maturity investments, partially offset by an increase in the net sales of equity securities.

Financing activities provided \$2.6 million and used \$11.0 million of net cash for the nine months ended September 30, 2006 and 2005, respectively. The change is primarily due to an increase in the issuance of common stock.

Harleysville Group participates in a securities lending program whereby certain fixed maturity securities from the investment portfolio are loaned to other institutions for a short period of time in return for a fee. At September 30, 2006, Harleysville Group held cash collateral of \$132.2 million related to securities on loan with a market value of \$128.6 million. Harleysville Group's policy is to require initial collateral of 102% of the market value of loaned securities plus accrued interest, which is required to be maintained daily by the borrower at no less than 100% of such market value plus accrued interest over the life of the loan. Acceptable collateral includes cash and money market instruments, government securities, A-rated corporate obligations, AAA-rated asset-backed securities or GIC's and Funding Agreements from issuers rated A or better. The securities on loan to others have been segregated from the other invested assets on the balance sheet. In addition, the assets and liabilities have been grossed up to reflect the collateral held under the securities lending program and the obligation to return this collateral upon the return of the loaned securities.

Harleysville Group Inc. maintained \$16.2 million of cash and marketable securities at September 30, 2006 which are available for general corporate purposes including dividends, debt service, capital contributions to subsidiaries, acquisitions and the repurchase of stock. The Company has no material commitments for capital expenditures as of September 30, 2006.

On August 18, 2006, Harleysville Group Inc. entered into a credit agreement with HSBC Bank USA, National Association, as Administrative Agent, and participating lenders relating to a five year \$100 million revolving credit facility. At Harleysville Group Inc.'s election, interest will be calculated at the LIBOR Rate plus a Margin or the Alternate Base Rate (the greater of the Prime Rate or the Federal Funds Effective Rate plus 1/2 of

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Management's Discussion and Analysis of Financial Condition  
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1%). In addition, there is a fee of 0.10% per annum on the loan commitment amount, regardless of usage. The agreement requires compliance with certain covenants, which include minimum net worth and leverage and fixed charge coverage ratios. The credit facility is available for general corporate purposes. There have been no borrowings under the credit facility.

The timing of future cash payments associated with unpaid losses and loss settlement expenses and contractual obligations pursuant to debt agreements is not expected to be materially different from that disclosed in the Company's Annual Report on Form 10-K for fiscal year 2005.

**RISK FACTORS**

The business, results of operations and financial condition, and therefore the value of Harleysville Group's securities, are subject to a number of risks. Some of those risks are set forth in the Company's Annual Report on Form 10-K for fiscal year 2005, filed with the Securities and Exchange Commission on March 10, 2006. There has been no material change from risk factors as previously disclosed in the Company's Annual Report for fiscal year 2005.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Item 3. Quantitative and Qualitative Disclosure  
About Market Risk**

Harleysville Group's market risk generally represents the risk of gain or loss that may result from the potential change in the fair value of Harleysville Group's investment portfolio as a result of fluctuations in prices and interest rates. Harleysville Group attempts to manage its interest rate risk by maintaining an appropriate relationship between the average duration of the investment portfolio and the approximate duration of its liabilities.

Harleysville Group has maintained approximately the same duration of its investment portfolio to its liabilities from December 31, 2005 to September 30, 2006. During the second quarter of 2006, the Company reduced its holdings of equity investments by approximately \$120 million and invested the proceeds in fixed maturity securities.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****Item 4.****Controls and Procedures**

- (a) Evaluation of disclosure controls and procedures. Our management, under the supervision and with the participation of the chief executive officer and the chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2006, which is the end of the period covered by this quarterly report on Form 10-Q. Based on that evaluation, the chief executive officer and chief financial officer have concluded that these disclosure controls and procedures are sufficient to provide that (a) material information relating to us, including our consolidated subsidiaries, is made known to these officers by other employees of us and our consolidated subsidiaries, particularly material information related to the period for which this periodic report is being prepared; and (b) this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the rules and forms of the Securities and Exchange Commission.
- (b) Change in internal control over financial reporting. There was no change in the Company's internal control over financial reporting that occurred during the third quarter of 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES****PART II. OTHER INFORMATION**

## ITEM 1A. Risk Factors

For a discussion of risk factors applicable to the Company, see page 30 "Risk Factors."

## ITEM 6. a. Exhibits

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURE**

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.

**Harleysville Group Inc.**

Date: November 6, 2006

By: /s/ ARTHUR E. CHANDLER  
Arthur E. Chandler  
Senior Vice President and  
Chief Financial Officer  
(principal financial officer)