

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, 2001.

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

51-0241172

(State or other jurisdiction of
incorporation or organization)

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

355 Maple Avenue, Harleysville, Pennsylvania 19438-2297

(Address of principal executive offices, including zip code)

(215) 256-5000

(Registrant's telephone number, including area code)

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 .

At November 7, 2001, 29,411,198 shares of common stock of Harleysville Group Inc. were outstanding.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**INDEX**

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HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	<u>September 30,</u> <u>2001</u>	<u>December 31,</u> <u>2000</u>
	(Unaudited)	
<u>Assets</u>		
Investments:		
Fixed maturities:		
Held to maturity, at amortized cost (fair value \$472,727 and \$578,662)	\$ 446,127	\$ 562,603
Available for sale, at fair value (amortized cost \$909,076 and \$800,954)	957,257	818,891
Equity securities, at fair value (cost \$115,778 and \$125,517)	146,696	193,750
Short-term investments, at cost, which approximates fair value	<u>44,274</u>	<u>23,881</u>
Total investments	1,594,354	1,599,125
Cash	12,275	28,395
Receivables:		
Premiums	124,027	101,511
Reinsurance	76,479	76,841
Accrued investment income	<u>21,015</u>	<u>23,316</u>
Total receivables	221,521	201,668
Deferred policy acquisition costs	89,061	84,759
Prepaid reinsurance premiums	18,009	18,154
Property and equipment, net	28,384	27,621
Deferred income taxes	27,750	19,545
Due from affiliate	5,634	
Other assets	<u>36,952</u>	<u>42,595</u>
Total assets	<u>\$2,033,940</u>	<u>\$2,021,862</u>
<u>Liabilities and Shareholders' Equity</u>		
Liabilities:		
Unpaid losses and loss settlement expenses	\$ 867,747	\$ 864,843
Unearned premiums	384,213	354,098
Accounts payable and accrued expenses	99,818	120,210
Debt	96,055	96,450
Due to affiliate		<u>19,680</u>
Total liabilities	<u>1,447,833</u>	<u>1,455,281</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 30,404,004 and 30,001,852 shares; outstanding 29,404,004 and 29,001,852 shares	30,404	30,002
Additional paid-in capital	139,293	131,537
Accumulated other comprehensive income	51,414	56,010
Retained earnings	380,561	364,597
Treasury stock, at cost, 1,000,000 shares	<u>(15,565)</u>	<u>(15,565)</u>
Total shareholders' equity	<u>586,107</u>	<u>566,581</u>
Total liabilities and shareholders' equity	<u>\$2,033,940</u>	<u>\$2,021,862</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, 2001 and 2000
(dollars in thousands, except per share data)

	<u>2001</u>	<u>2000</u>
Revenues:		
Premiums earned	\$184,804	\$171,938
Investment income, net of investment expenses	21,388	21,590
Realized investment gains (losses)	(4,154)	2,587
Other income	<u>3,783</u>	<u>4,037</u>
Total revenues	<u>205,821</u>	<u>200,152</u>
Losses and expenses:		
Losses and loss settlement expenses	134,275	121,890
Amortization of deferred policy acquisition costs	44,839	44,369
Other underwriting expenses	15,561	14,787
Interest expense	1,515	1,668
Other expenses	<u>1,206</u>	<u>1,702</u>
Total expenses	<u>197,396</u>	<u>184,416</u>
Income before income taxes	8,425	15,736
Income taxes	<u>570</u>	<u>2,696</u>
Net income	<u>\$ 7,855</u>	<u>\$ 13,040</u>
Per common share:		
Basic earnings	<u>\$.27</u>	<u>\$.45</u>
Diluted earnings	<u>\$.26</u>	<u>\$.45</u>
Cash dividend	<u>\$.15</u>	<u>\$.14</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, 2001 and 2000
(dollars in thousands, except per share data)

	<u>2001</u>	<u>2000</u>
Revenues:		
Premiums earned	\$541,450	\$513,872
Investment income, net of investment expenses	63,856	64,874
Realized investment gains (losses)	(7,532)	5,226
Other income	<u>11,809</u>	<u>12,533</u>
Total revenues	<u>609,583</u>	<u>596,505</u>
Losses and expenses:		
Losses and loss settlement expenses	387,936	374,409
Amortization of deferred policy acquisition costs	134,496	132,913
Other underwriting expenses	45,913	44,715
Interest expense	4,701	4,946
Other expenses	<u>4,182</u>	<u>4,889</u>
Total expenses	<u>577,228</u>	<u>561,872</u>
Income before income taxes	32,355	34,633
Income taxes	<u>3,804</u>	<u>3,647</u>
Net income	<u>\$ 28,551</u>	<u>\$ 30,986</u>
Per common share:		
Basic earnings	<u>\$.98</u>	<u>\$ 1.08</u>
Diluted earnings	<u>\$.96</u>	<u>\$ 1.07</u>
Cash dividend	<u>\$.43</u>	<u>\$.41</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, 2001
(dollars in thousands)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>					
Balance, December 31, 2000	30,001,852	\$30,002	\$131,537	\$56,010	\$364,597	\$(15,565)	<u>\$566,581</u>
Net income					28,551		28,551
Other compre- hensive income, net of tax: Unrealized investment (losses), net of reclassification adjustment				(4,596)			<u>(4,596)</u>
Comprehensive income							<u>23,955</u>
Issuance of common stock	402,152	402	7,756				8,158
Cash dividend paid					(12,587)		<u>(12,587)</u>
Balance, September 30, 2001	<u>30,404,004</u>	<u>\$30,404</u>	<u>\$139,293</u>	<u>\$51,414</u>	<u>\$380,561</u>	<u>\$(15,565)</u>	<u>\$586,107</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, 2001 and 2000
(in thousands)

	<u>2001</u>	<u>2000</u>
Cash flows from operating activities:		
Net income	\$ 28,551	\$ 30,986
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in receivables, unearned premiums, prepaid reinsurance and due to affiliate	(14,907)	(23,140)
Increase (decrease) in unpaid losses and loss settlement expenses	2,904	(2,798)
Deferred income taxes	(5,590)	(2,259)
Increase in deferred policy acquisition costs	(4,302)	(2,417)
Amortization and depreciation	2,121	2,567
(Gain) loss on sale of investments	7,532	(5,226)
Other, net	(14,492)	3,262
Net cash provided by operating activities	<u>1,817</u>	<u>975</u>
Cash flows from investing activities:		
Fixed maturity investments:		
Purchases	(198,924)	(87,540)
Sales or maturities	210,260	81,164
Equity securities:		
Purchases	(7,477)	(22,686)
Sales	6,970	16,152
Net (purchases) sales of short-term investments	(20,393)	37,852
Purchase of property and equipment	(2,474)	(2,533)
Net cash provided (used) by investing activities	<u>(12,038)</u>	<u>22,409</u>
Cash flows from financing activities:		
Issuance of common stock	7,083	4,316
Payment of debt obligations	(395)	(360)
Dividends paid	(12,587)	(11,804)
Purchase of treasury stock	—	(4,711)
Net cash used by financing activities	<u>(5,899)</u>	<u>(12,559)</u>
Increase (decrease) in cash	(16,120)	10,825
Cash at beginning of period	<u>28,395</u>	<u>20,273</u>
Cash at end of period	<u>\$ 12,275</u>	<u>\$ 31,098</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, consisting of normal recurring 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, 2000 included in the Company's 2000 Annual Report filed with the Securities and Exchange Commission on Form 10-K.

2 - 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,	
	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000</u>
	(in thousands, except per share data)			
Numerator for basic and diluted earnings per share:				
Net income	<u>\$ 7,855</u>	<u>\$13,040</u>	<u>\$28,551</u>	<u>\$30,986</u>
Denominator for basic earnings per share -- weighted average shares outstanding	29,359	28,787	29,235	28,817
Effect of stock incentive plans	<u>610</u>	<u>252</u>	<u>596</u>	<u>211</u>
Denominator for diluted earnings per share	<u>29,969</u>	<u>29,039</u>	<u>29,831</u>	<u>29,028</u>
Basic earnings per share	<u>\$.27</u>	<u>\$.45</u>	<u>\$.98</u>	<u>\$ 1.08</u>
Diluted earnings per share	<u>\$.26</u>	<u>\$.45</u>	<u>\$.96</u>	<u>\$ 1.07</u>

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

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,	
	2001	2000	2001	2000
	(in thousands)			
Number of options	<u>-</u>	<u>582</u>	<u>444</u>	<u>1,252</u>

3 - Reinsurance

Premiums earned are net of amounts ceded of \$15,095,000 and \$46,098,000 for the three and nine months ended September 30, 2001, respectively, and \$18,825,000 and \$59,659,000 for the three and nine months ended September 30, 2000, respectively. Losses and loss settlement expenses are net of amounts ceded of \$17,070,000 and \$53,034,000 for the three and nine months ended September 30, 2001, respectively, and \$16,278,000 and \$43,046,000 for the three and nine months ended September 30, 2000, respectively. Such amounts do not include the reinsurance transactions with Mutual under the pooling arrangement, but do include the reinsurance described in the following paragraph.

Harleysville Group has a reinsurance agreement with Harleysville Mutual Insurance Company (Mutual) whereby Mutual reinsures 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 excludes catastrophe losses resulting from earthquakes or hurricanes, and supplements the existing external catastrophe reinsurance program. Harleysville Group ceded to Mutual premiums earned of \$1,898,000 and \$1,751,000 and losses incurred of \$3,447,000 and \$2,570,000 for the three months ended September 30, 2001 and 2000, respectively. Harleysville Group ceded to Mutual premiums earned of \$5,379,000 and \$5,125,000 and losses incurred of \$8,439,000 and \$4,281,000 for the nine months ended September 30, 2001 and 2000, respectively.

Harleysville Group cedes business to and assumes business from Mutual under a reinsurance pooling agreement. Because this agreement does not relieve Harleysville Group of primary liability as the originating insurer, there is a concentration of credit risk arising from business ceded to Mutual. However, the

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

reinsurance pooling agreement provides for the right of offset and the net pooling balance with Mutual is a liability at September 30, 2001 and December 31, 2000. Mutual has an A. M. Best rating of "A" (Excellent) and, in accordance with certain state regulatory requirements, maintained \$328.7 million (fair value) of investments in a trust account to secure liabilities under the reinsurance pooling agreement at September 30, 2001.

4 - Cash Flows

Net cash tax payments of \$7,183,000 and \$2,466,000 were made in the first nine months of 2001 and 2000, respectively. Cash interest payments of \$3,361,000 and \$3,566,000 were made in the first nine months of 2001 and 2000, respectively.

5 - Restructuring Charges

On July 29, 1999, Harleysville Group announced a plan to consolidate its claims operations from 23 general claims offices into a centralized direct reporting center and four specialized regional claims centers. As a result of this consolidation, the Company recorded a restructuring charge in 1999 for employee termination benefits to be paid and occupancy charges.

Employee termination benefits include severance payments and related benefits and outplacement services for 173 employees. Severance payments totaling \$1,793,000 have been made to 172 employees, and the remaining accrual for employee termination benefits is \$10,000 at September 30, 2001. Included in occupancy charges are future lease obligations, less anticipated sublease benefits, for leased premises which will no longer be used by the claims operation. Through September 30, 2001, operations in the 23 general claims offices have been closed. Payments totaling \$513,000 have been made, and the remaining accrual for occupancy charges is \$106,000 at September 30, 2001.

On February 7, 2000, Harleysville Group announced a plan to consolidate selected support services and office functions throughout its field operations. As a result of this consolidation, the Company recorded a restructuring charge in 2000 for employee termination benefits to be paid, occupancy charges and a write-down of equipment to fair value. This charge was included in other underwriting expenses.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

Employee termination benefits include severance payments and related benefits and outplacement services for 109 field employees. Severance payments totaling \$883,000 have been made to the 109 employees. Included in occupancy charges is a future lease obligation, less anticipated sublease benefits, for leased premises which will no longer be used. Payments totaling \$100,000 have been made against the accrual for occupancy charges. Also, as a direct result of the consolidation, a loss of \$52,000 was realized in 2000 on the disposal of equipment.

Both consolidations were completed in 2000.

Activity in the Restructuring Accruals
(in thousands)

	<u>Claims</u>			<u>Field</u>		
	<u>Restructuring</u>			<u>Restructuring</u>		
	<u>Employee</u>			<u>Employee</u>		
	<u>Termination</u>	<u>Occupancy</u>	<u>Total</u>	<u>Termination</u>	<u>Occupancy</u>	<u>Total</u>
	<u>Benefits</u>			<u>Benefits</u>		
Restructuring charge	\$ 2,017	\$ 594	\$ 2,611			
Change in prior accrual due to voluntary terminations and additional sublease benefits	(42)	(57)	(99)			
Balance at December 31, 1999	<u>\$ 1,975</u>	<u>\$ 537</u>	<u>\$ 2,512</u>			
Restructuring charge				\$ 899	\$188	\$1,087
Cash payments	(1,793)	(371)	(2,164)	(883)	(50)	(933)
Change in prior accrual due to voluntary terminations greater than anticipated and reduced sublease benefits	(172)	50	(122)	(16)		(16)
Balance at December 31, 2000	10	216	226		138	138
Cash payments		(142)	(142)		(50)	(50)
Change in prior accrual due to reduced sublease benefits		32	32			
Balance at Sept. 30, 2001	<u>\$ 10</u>	<u>\$ 106</u>	<u>\$ 116</u>	<u>\$</u>	<u>\$ 88</u>	<u>\$ 88</u>

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

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).

Financial data by segment is as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000</u>
	(in thousands)			
Revenues:				
Premiums earned:				
Commercial lines	\$126,031	\$109,256	\$362,412	\$325,332
Personal lines	<u>58,773</u>	<u>62,682</u>	<u>179,038</u>	<u>188,540</u>
Total premiums earned	184,804	171,938	541,450	513,872
Net investment income	21,388	21,590	63,856	64,874
Realized investment gains (losses)	(4,154)	2,587	(7,532)	5,226
Other	<u>3,783</u>	<u>4,037</u>	<u>11,809</u>	<u>12,533</u>
Total revenues	<u>\$205,821</u>	<u>\$200,152</u>	<u>\$609,583</u>	<u>\$596,505</u>
Income before income taxes:				
Underwriting loss:				
Commercial lines	\$ (4,984)	\$ (5,948)	\$ (7,462)	\$ (23,493)
Personal lines	<u>(5,925)</u>	<u>(4,367)</u>	<u>(24,278)</u>	<u>(18,930)</u>
SAP underwriting loss	(10,909)	(10,315)	(31,740)	(42,423)
GAAP adjustments	<u>1,038</u>	<u>1,207</u>	<u>4,845</u>	<u>4,258</u>
GAAP underwriting loss	(9,871)	(9,108)	(26,895)	(38,165)
Net investment income	21,388	21,590	63,856	64,874
Realized investment gains (losses)	(4,154)	2,587	(7,532)	5,226
Other	<u>1,062</u>	<u>667</u>	<u>2,926</u>	<u>2,698</u>
Income before income taxes	<u>\$ 8,425</u>	<u>\$ 15,736</u>	<u>\$ 32,355</u>	<u>\$ 34,633</u>

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

7 - Comprehensive Income

Comprehensive income consisted of the following (all amounts are net of taxes):

	<u>For the three months ended September 30, 2001</u>	<u>2000</u>	<u>For the nine months ended September 30, 2001</u>	<u>2000</u>
	(in thousands)			
Net income	\$ 7,855	\$13,040	\$28,551	\$30,986
Other comprehensive income:				
Unrealized investment holding gains (losses) arising during period	(3,169)	6,706	(9,581)	15,986
Less:				
Reclassification adjustment for (gains) losses included in net income	<u>2,769</u>	<u>(1,677)</u>	<u>4,985</u>	<u>(3,392)</u>
Net unrealized investment gains (losses)	<u>(400)</u>	<u>5,029</u>	<u>(4,596)</u>	<u>12,594</u>
Comprehensive income	<u>\$ 7,455</u>	<u>\$18,069</u>	<u>\$23,955</u>	<u>\$43,580</u>

8 - New Accounting Standards

Harleysville Group transferred investments with an amortized cost of \$81.0 million and unrealized gains of \$1.5 million from the held to maturity classification to the available for sale classification on January 1, 2001, under the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, an amendment of SFAS No. 133." Harleysville Group has no derivative instruments or hedging activities.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

9 - New Statutory Accounting Principles

The NAIC has adopted the Codification of Statutory Accounting Principles with an effective date of January 1, 2001. The codification principles are intended to provide a basis of accounting recognized and adhered to in the absence of, conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the statutory capital and surplus of the Company's insurance subsidiaries ranges from (2%) to 9% of statutory capital and surplus and, on a consolidated basis, increases statutory capital and surplus by approximately 7%.

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

Results of Operations

Premiums earned increased \$12.9 million and \$27.6 million during the three and nine months ended September 30, 2001, respectively. The increases are primarily due to increases in premiums earned for commercial lines of \$16.8 million and \$37.1 million offset by decreases of \$3.9 million and \$9.5 million in personal lines premiums earned for the three and nine months ended September 30, 2001, respectively. The increases in premiums earned for commercial lines primarily is due to higher rates partially offset by fewer policy counts. The decreases in premiums earned for personal lines primarily is due to fewer policy counts partially offset by higher rates.

Investment income decreased \$0.2 million and \$1.0 million for the three and nine months ended September 30, 2001 as a decrease in invested assets was offset by a higher yield on the investment portfolio. The higher yield primarily is due to having a greater proportion of taxable fixed maturity investments. During the third quarter of 2001, \$16.6 million of cash was added to the investment portfolio. Because reinvestment interest rates are lower, the trend of lower investment income, particularly on an after tax basis, is expected to continue in the fourth quarter of 2001.

Realized investment gains (losses) decreased \$6.7 million and \$12.8 million for the three and nine months ended September 30, 2001, respectively, primarily resulting from lesser sales of equity securities and from increases of \$1.8 million and \$8.8 million, respectively, in losses recognized on equity investments that were trading below cost on an other-than-temporary basis. Such increased losses for the nine months ended September 30, 2001 were partially offset by greater gains on the sale of fixed maturity securities.

Income before income taxes decreased \$7.3 million and \$2.3 million for the three and nine months ended September 30, 2001, respectively. The decreases were primarily due to the lower investment income and lower realized gains (losses) for the three and nine months ended September 30, 2001. For the nine months ended September 30, 2001, these decreases were partially offset by a lower underwriting loss. Harleysville Group's statutory combined ratio was 104.6% for both the three months ended September 30, 2001 and 2000 and decreased to 104.1% for the nine months ended September 30, 2001 from 107.3% for the nine months ended September 30, 2000. The nine months ended September 30, 2000

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

include a pre-tax charge of \$1.1 million (\$.03 per basic share after taxes) related to the consolidation of selected non-claims support services and office functions throughout the field operations. This restructuring charge adversely affected the statutory combined ratio by 0.2 points for the nine months ended September 30, 2000. Income before income taxes for the nine months ended September 30, 2000 also was reduced by \$1.9 million (\$0.04 per basic share after taxes) to reflect the effect of a settlement of litigation between the North Carolina Rate Bureau and the Commissioner of Insurance over personal automobile insurance rate levels dating back to 1994. The settlement, which mandates a refund of premium be made to policyholders, adversely affected the combined ratio by 0.5 points. Excluding the impacts of the field restructuring and North Carolina Rate Bureau settlement, the statutory combined ratio decreased 2.5 points for the nine months ended September 30, 2001. Such decrease is primarily due to better results in commercial lines partially offset by worse results in personal lines. The improvement in commercial lines primarily is due to benefits from higher pricing, re-underwriting and agency management efforts partially offset by \$3.6 million of net estimated losses resulting from the September 11 terrorist acts. While the trend of improving commercial lines results is expected to continue in 2002, commercial lines may not improve in the fourth quarter of 2001 as compared to the fourth quarter of 2000 as workers compensation losses have been trending higher than those reported in the fourth quarter of 2000. The decline in personal lines profitability primarily is due to higher loss trends in the personal automobile lines.

In October 2001, Reliance Insurance Company was ordered liquidated and it is expected that various state guaranty funds will levy assessments in the fourth quarter of 2001. It is currently estimated that such assessments will result in a charge to Harleysville Group ranging from \$1 million to \$4 million before taxes in the fourth quarter of 2001.

The terrorist acts of September 11, 2001 have given rise to concerns about the availability and pricing of reinsurance for the property and casualty industry. Harleysville Group's catastrophe reinsurance treaty provides coverage through June 30, 2002 and our casualty reinsurance treaties expire December 31, 2001. As future reinsurance prices and terms may be less favorable, Harleysville Group is working closely with its reinsurers and monitoring the progress of proposals for federal government solutions to the reinsurance coverage availability and pricing issues.

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

The income tax provision for the three and nine months ended September 30, 2001 includes the tax benefit of \$2.4 million and \$7.6 million associated with tax-exempt investment income, compared to \$2.9 million and \$8.6 million in the same prior year periods.

New Accounting Standards

In July 2001, the FASB issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires the purchase method of accounting to be used for all future business combinations and contains provisions for the accounting for goodwill and intangible assets. SFAS No. 142 is effective January 1, 2002 and will require that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be evaluated for impairment.

At September 30, 2001, Harleysville Group has unamortized goodwill in the amount of \$23.6 million which will be subject to transition provisions of SFAS No. 141 and 142. Amortization expense related to goodwill was \$0.6 million for both the nine month periods ended September 30, 2001 and 2000. Harleysville Group has not yet determined an estimate of the impact of adopting SFAS No. 141 and 142 on its financial statements at the date of this report.

Liquidity and Capital Resources

Net cash provided by operating activities increased \$0.8 million for the nine months ended September 30, 2001. The increase primarily resulted from a decrease in cash used by underwriting activities partially offset by a decrease of \$26.5 million in cash held as collateral for security lending transactions.

Net cash used by investing activities was \$12.0 million for the nine months ended September 30, 2001 and net cash of \$22.4 million was provided by investing activities for the nine months ended September 30, 2000. The change is primarily due to the increase in cash provided by operating activities and decreased cash used in financing activities.

Net cash used by financing activities decreased \$6.7 million for the nine months ended September 30, 2001 primarily due to the purchase of treasury stock in 2000 and an increase in the issuance of common stock in 2001.

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

Harleysville Group Inc. maintained \$5.9 million of cash and marketable securities at September 30, 2001 which is available for general corporate business purposes including dividends, debt service, capital contributions to subsidiaries, acquisitions and the repurchase of stock. The Company had no material commitments for capital expenditures as of September 30, 2001.

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; natural 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; and the status of labor markets in which the Company operates.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**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, 2000 to September 30, 2001. In addition, the Company has not significantly changed its investment mix during this period.

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

- ITEM 1. Legal Proceedings - None
- ITEM 2. Changes in Securities - None
- ITEM 3. Defaults Upon Senior Securities - None
- ITEM 4. Submission of Matters to a Vote of Security Holders - None
- ITEM 5. Other Information - None
- ITEM 6. a. Exhibits - None
b. Reports on Form 8-K - None

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 13, 2001

/s/BRUCE J. MAGEE
Bruce J. Magee
Senior Vice President and
Chief Financial Officer
(principal financial officer and
principal accounting officer)