

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, 2004.

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, 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 .

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes . No .

At November 1, 2004, 30,127,684 shares of common stock of Harleysville Group Inc. 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>2004</u>	<u>December 31,</u> <u>2003</u>
	(Unaudited)	
<u>Assets</u>		
Investments:		
Fixed maturities:		
Held to maturity, at amortized cost (fair value \$530,912 and \$463,953)	\$ 509,387	\$ 436,521
Available for sale, at fair value (amortized cost \$1,006,747 and \$980,936)	1,051,849	1,033,855
Equity securities, at fair value (cost \$110,033 and \$97,189)	141,497	137,590
Short-term investments, at cost, which approximates fair value	94,212	31,411
Fixed maturity securities on loan		
Held to maturity, at amortized cost (fair value \$1,530 and \$3,532)	1,454	3,092
Available for sale, at fair value (amortized cost \$111,399 and \$202,222)	115,564	212,164
Total investments	<u>1,913,963</u>	<u>1,854,633</u>
Cash	1,037	13,430
Receivables:		
Premiums	143,166	140,674
Reinsurance (affiliate \$752 and \$699)	176,052	164,841
Accrued investment income	21,442	23,086
Total receivables	<u>340,660</u>	<u>328,601</u>
Deferred policy acquisition costs	103,376	99,033
Prepaid reinsurance premiums	32,442	30,899
Property and equipment, net	21,291	23,824
Deferred income taxes	52,424	43,020
Securities lending collateral	120,888	221,454
Due from affiliate	6,833	
Other assets	45,814	65,495
Total assets	<u>\$2,638,728</u>	<u>\$2,680,389</u>
<u>Liabilities and Shareholders' Equity</u>		
Liabilities:		
Unpaid losses and loss settlement expenses (affiliate \$198,144 and \$189,891)	\$1,280,820	\$1,219,977
Unearned premiums (affiliate \$51,718 and \$52,839)	451,219	437,883
Accounts payable and accrued expenses	82,557	91,999
Security lending obligation	120,888	221,454
Debt (affiliate \$18,500 and \$18,500)	119,625	120,145
Due to affiliate		16,184
Total liabilities	<u>2,055,109</u>	<u>2,107,642</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 31,510,885 and 31,298,532 shares; outstanding 30,112,976 and 29,900,623 shares	31,511	31,299
Additional paid-in capital	160,358	156,997
Accumulated other comprehensive income	45,805	60,450
Retained earnings	370,632	350,844
Deferred compensation	(200)	(2,356)
Treasury stock, at cost, 1,397,909 shares	(24,487)	(24,487)
Total shareholders' equity	<u>583,619</u>	<u>572,747</u>
Total liabilities and shareholders' equity	<u>\$2,638,728</u>	<u>\$2,680,389</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, 2004 and 2003
(dollars in thousands, except per share data)

	<u>2004</u>	<u>2003</u>
Revenues:		
Premiums earned from affiliate (ceded to affiliate, \$188,868 and \$182,808)	\$212,641	\$209,177
Investment income, net of investment expenses	21,499	21,638
Realized investment gains (losses), net	104	(531)
Other income (affiliate \$1,755 and \$1,844)	<u>4,024</u>	<u>3,838</u>
Total revenues	<u>238,268</u>	<u>234,122</u>
Losses and expenses:		
Losses and loss settlement expenses from affiliate (ceded to affiliate, \$129,248 and \$188,437)	153,944	217,456
Amortization of deferred policy acquisition costs	52,150	51,838
Other underwriting expenses	18,154	18,214
Interest expense (affiliate \$100 and \$77)	1,587	2,609
Other expenses	<u>2,764</u>	<u>1,596</u>
Total expenses	<u>228,599</u>	<u>291,713</u>
Income (loss) before income taxes	9,669	(57,591)
Income taxes (benefit)	<u>789</u>	<u>(22,937)</u>
Net income (loss)	<u>\$ 8,880</u>	<u>\$ (34,654)</u>
Per common share:		
Basic earnings (loss)	<u>\$.30</u>	<u>\$ (1.16)</u>
Diluted earnings (loss)	<u>\$.29</u>	<u>\$ (1.16)</u>
Cash dividend	<u>\$.17</u>	<u>\$.17</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, 2004 and 2003
(dollars in thousands, except per share data)

	<u>2004</u>	<u>2003</u>
Revenues:		
Premiums earned from affiliate (ceded to affiliate, \$553,663 and \$531,489)	\$627,241	\$611,761
Investment income, net of investment expenses	64,578	64,734
Realized investment gains (losses), net	12,651	(897)
Other income (affiliate \$5,210 and \$5,675)	<u>12,259</u>	<u>12,431</u>
Total revenues	<u>716,729</u>	<u>688,029</u>
Losses and expenses:		
Losses and loss settlement expenses from affiliate (ceded to affiliate, \$391,030 and \$456,627)	453,765	528,641
Amortization of deferred policy acquisition costs	153,536	150,053
Other underwriting expenses	57,518	54,892
Interest expense (affiliate \$268 and \$263)	4,730	5,396
Other expenses	<u>5,449</u>	<u>3,983</u>
Total expenses	<u>674,998</u>	<u>742,965</u>
Income (loss) before income taxes	41,731	(54,936)
Income taxes (benefit)	<u>6,630</u>	<u>(27,110)</u>
Net income (loss)	<u>\$ 35,101</u>	<u>\$ (27,826)</u>
Per common share:		
Basic earnings (loss)	<u>\$ 1.17</u>	<u>\$ (.93)</u>
Diluted earnings (loss)	<u>\$ 1.17</u>	<u>\$ (.93)</u>
Cash dividend	<u>\$.51</u>	<u>\$.50</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, 2004
(dollars in thousands)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Retained Earnings</u>	<u>Deferred Compensation</u>	<u>Treasury Stock</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>						
Balance, December 31, 2003	31,298,532	\$31,299	\$156,997	\$ 60,450	\$350,844	\$(2,356)	\$(24,487)	<u>\$572,747</u>
Net income					35,101			35,101
Other compre- hensive loss, net of tax: Unrealized investment losses, net of reclassification adjustment				(14,645)				<u>(14,645)</u>
Comprehensive income								20,456
Issuance of common stock	212,353	212	3,423					3,635
Tax on stock compensation			(62)					(62)
Deferred compensation						2,156		2,156
Cash dividend paid					(15,313)			<u>(15,313)</u>
Balance at September 30, 2004	<u>31,510,885</u>	<u>\$31,511</u>	<u>\$160,358</u>	<u>\$ 45,805</u>	<u>\$370,632</u>	<u>\$(200)</u>	<u>\$(24,487)</u>	<u>\$583,619</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, 2004 and 2003
(in thousands)

	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:		
Net income (loss)	\$ 35,101	\$ (27,826)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Change in receivables, unearned premiums and prepaid reinsurance balances	(266)	(43,904)
Change in affiliate balance	(23,017)	2,800
Increase in unpaid losses and loss settlement expenses	60,843	226,013
Deferred income taxes	(1,518)	(18,745)
Increase in deferred policy acquisition costs	(4,343)	(8,038)
Amortization and depreciation	4,017	3,383
Loss (gain) on sale of investments	(12,651)	897
Other, net	12,029	(21,269)
Net cash provided by operating activities	<u>70,195</u>	<u>113,311</u>
Cash flows from investing activities:		
Fixed maturity investments:		
Purchases	(157,879)	(329,352)
Sales or maturities	151,491	197,253
Equity securities:		
Purchases	(25,447)	(14,674)
Sales	25,064	13,616
Net purchases of short-term investments	(62,801)	(64,405)
Sale (purchase) of property and equipment	(818)	616
Net cash used by investing activities	<u>(70,390)</u>	<u>(196,946)</u>
Cash flows from financing activities:		
Issuance of common stock	3,635	8,214
Issuance of debt		100,000
Repayment of debt obligation	(520)	(475)
Dividend paid (to affiliate, \$8,671 and \$8,375)	(15,313)	(15,023)
Purchase of treasury stock		(7,497)
Net cash provided (used) by financing activities	<u>(12,198)</u>	<u>85,219</u>
Increase (decrease) in cash	(12,393)	1,584
Cash at beginning of period	<u>13,430</u>	<u>2,944</u>
Cash at end of period	<u>\$ 1,037</u>	<u>\$ 4,528</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 only 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, 2003 included in the Company's 2003 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 56% of the outstanding common stock of Harleysville Group Inc. As used herein, "Harleysville Group" refers to Harleysville Group Inc. and Subsidiaries.

Policy Acquisition Costs

Policy acquisition costs, such as commissions, premium taxes and certain other underwriting and agency expenses that vary with, and are directly related to, the production of business, are deferred and amortized over the effective period of the related insurance policies 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.

Stock-Based Compensation

Stock-based compensation plans are accounted for under the provisions of Accounting Principles Board (APB) Opinion No. 25,

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

"Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no compensation expense is recognized for fixed stock option grants and an employee stock purchase plan. Compensation expense would be recorded on the date of a stock option grant only if the current market price of the underlying stock exceeded the exercise price. 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, 2004 and 2003:

	For the three months ended September 30,		For the nine months ended September 30,	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
	(in thousands, except per share data)			
Net income (loss), as reported	\$8,880	\$(34,654)	\$35,101	\$(27,826)
Plus:				
Stock-based employee compensation expense (benefit) included in reported net income (loss), net of related tax effects	199	155	253	(301)
Less:				
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(764)</u>	<u>(855)</u>	<u>(2,216)</u>	<u>(1,940)</u>
Pro forma net income (loss)	<u>\$8,315</u>	<u>\$(35,354)</u>	<u>\$33,138</u>	<u>\$(30,067)</u>
Basic earnings (loss) per share:				
As reported	\$.30	\$ (1.16)	\$ 1.17	\$ (.93)
Pro forma	\$.28	\$ (1.18)	\$ 1.10	\$ (1.00)
Diluted earnings (loss) per share:				
As reported	\$.29	\$ (1.16)	\$ 1.17	\$ (.93)
Pro forma	\$.28	\$ (1.18)	\$ 1.10	\$ (1.00)

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

2 - Earnings Per Share

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2004	2003	2004	2003
	<u>(in thousands, except per share data)</u>			
Numerator for basic and diluted earnings (loss) per share:				
Net income (loss)	<u>\$ 8,880</u>	<u>\$ (34,654)</u>	<u>\$35,101</u>	<u>\$ (27,826)</u>
Denominator for basic earnings per share -- weighted average shares outstanding	30,063	29,986	29,995	30,017
Effect of stock incentive plans	<u>90</u>	<u> </u>	<u>96</u>	<u> </u>
Denominator for diluted earnings (loss) per share	<u>30,153</u>	<u>29,986</u>	<u>30,091</u>	<u>30,017</u>
Basic earnings (loss) per share	<u>\$.30</u>	<u>\$ (1.16)</u>	<u>\$ 1.17</u>	<u>\$ (.93)</u>
Diluted earnings (loss) per share	<u>\$.29</u>	<u>\$ (1.16)</u>	<u>\$ 1.17</u>	<u>\$ (.93)</u>

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,	
	2004	2003	2004	2003
	<u>(in thousands)</u>			
Number of options	<u>1,608</u>	<u>1,510</u>	<u>1,608</u>	<u>1,111</u>

An additional 803,223 and 1,203,004 options to purchase shares of common stock were not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2003, respectively, because their inclusion would have had an antidilutive effect.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

3 - Reinsurance

Premiums earned are net of amounts ceded of \$22,051,000 and \$66,108,000 for the three and nine months ended September 30, 2004, respectively, and \$17,129,000 and \$51,589,000 for the three and nine months ended September 30, 2003, respectively. Losses and loss settlement expenses are net of amounts ceded of \$13,592,000 and \$53,308,000 for the three and nine months ended September 30, 2004, respectively, and \$57,228,000 and \$94,734,000 for the three and nine months ended September 30, 2003, respectively. Such amounts 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. Of the losses and loss settlement expenses ceded for the three months ended September 30, 2003, \$53.7 million is for losses ceded to involuntary reinsurance mechanisms and reflect increased estimates of losses on lifetime medical cases. Of this \$53.7 million, \$48.7 million is ceded to the Michigan Catastrophic Claims Association (MCCA) which covers no-fault first party medical losses in excess of a retention ranging from \$250,000 to \$325,000. Since these ceded losses are above the retention, the increased estimates had no net impact on results of operations.

Harleysville Group has a reinsurance agreement with 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, terrorism or hurricanes, and supplements the existing external catastrophe reinsurance program. Harleysville Group ceded to Mutual premiums earned of \$2,164,000 and \$2,108,000 and losses incurred of \$(440,000) and \$(140,000) for the three months ended September 30, 2004 and 2003, respectively. Harleysville Group ceded to Mutual premiums earned of \$6,424,000 and \$6,348,000 and losses incurred of \$544,000 and \$4,634,000 for the nine months ended September 30, 2004 and 2003, respectively.

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

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

Mutual. However, the reinsurance pooling agreement provides for the right of offset. Mutual has an A. M. Best rating of "A-" (Excellent).

4 - Cash Flows

Net cash tax payments (refunds) of \$(13,709,000) and \$1,096,000 were made (received) in the first nine months of 2004 and 2003, respectively. Cash interest payments of \$6,043,000 and \$2,817,000 were made in the first nine months of 2004 and 2003, respectively.

5 - 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,	
	2004	2003	2004	2003
	(in thousands)			
Revenues:				
Premiums earned:				
Commercial lines	\$169,680	\$161,412	\$495,791	\$ 464,279
Personal lines	<u>42,961</u>	<u>47,765</u>	<u>131,450</u>	<u>147,482</u>
Total premiums earned	212,641	209,177	627,241	611,761
Net investment income	21,499	21,638	64,578	64,734
Realized investment gains (losses)	104	(531)	12,651	(897)
Other	<u>4,024</u>	<u>3,838</u>	<u>12,259</u>	<u>12,431</u>
Total revenues	<u>\$238,268</u>	<u>\$234,122</u>	<u>\$716,729</u>	<u>\$ 688,029</u>
Income (loss) before income taxes:				
Underwriting gain (loss):				
Commercial lines	\$(13,517)	\$(63,953)	\$(39,523)	\$(100,726)
Personal lines	<u>344</u>	<u>(13,439)</u>	<u>(4,506)</u>	<u>(29,181)</u>
SAP underwriting loss	(13,173)	(77,392)	(44,029)	(129,907)
GAAP adjustments	<u>1,566</u>	<u>(939)</u>	<u>6,451</u>	<u>8,082</u>
GAAP underwriting loss	(11,607)	(78,331)	(37,578)	(121,825)
Net investment income	21,499	21,638	64,578	64,734
Realized investment gains (losses)	104	(531)	12,651	(897)
Other	<u>(327)</u>	<u>(367)</u>	<u>2,080</u>	<u>3,052</u>
Income (loss) before income taxes	<u>\$ 9,669</u>	<u>\$(57,591)</u>	<u>\$ 41,731</u>	<u>\$(54,936)</u>

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

6 - Comprehensive Income (Loss)

Comprehensive income (loss) for the three and nine months ended September 30, 2004 and 2003 consisted of the following (all amounts are net of taxes):

	<u>For the three months ended September 30, 2004</u>	<u>2003</u>	<u>For the nine months ended September 30, 2004</u>	<u>2003</u>
	(in thousands)			
Net income (loss)	\$ 8,880	\$ (34,654)	\$ 35,101	\$ (27,826)
Other comprehensive income (loss):				
Unrealized investment holding gains (losses) arising during period	8,152	(7,510)	(6,449)	9,412
Less:				
Reclassification adjustment for (gains) losses included in net income (loss)	<u>(65)</u>	<u>442</u>	<u>(8,196)</u>	<u>872</u>
Net unrealized investment gains (losses)	<u>8,087</u>	<u>(7,068)</u>	<u>(14,645)</u>	<u>10,284</u>
Comprehensive income (loss)	<u>\$16,967</u>	<u>\$ (41,722)</u>	<u>\$ 20,456</u>	<u>\$ (17,542)</u>

7 - Pension

Harleysville Group Inc. has a pension plan that covers substantially all full-time employees. The net periodic pension cost for the plan including Mutual consists of the following components:

	<u>For the three months ended September 30, 2004</u>	<u>2003</u>	<u>For the nine months ended September 30, 2004</u>	<u>2003</u>
	(in thousands)			
Components of net periodic pension cost:				
Service cost	\$ 2,007	\$ 1,658	\$ 5,992	\$ 4,975
Interest cost	2,821	2,507	8,361	7,522
Expected return on plan assets	(3,101)	(2,486)	(9,141)	(7,457)
Recognized net actuarial loss	600	13	1,635	38
Amortization of prior service cost	52	58	157	174
Net transition amortization	<u>14</u>	<u>13</u>	<u>39</u>	<u>40</u>
Net periodic pension cost:				
Entire plan	<u>\$ 2,393</u>	<u>\$ 1,763</u>	<u>\$ 7,043</u>	<u>\$ 5,292</u>
Harleysville Group portion	<u>\$ 1,589</u>	<u>\$ 1,153</u>	<u>\$ 4,658</u>	<u>\$ 3,606</u>

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

Harleysville Group contributed \$6,600,000 to the pension plan during the first nine months of 2004 and does not expect to make further contributions until 2005.

8 - Statutory Capital Requirements

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 2003 statutory financial statements, the ratio of total adjusted capital to the Authorized Control Level for the Company's nine insurance subsidiaries at December 31, 2003 ranged from 478% to 609%.

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

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

Overview

The Company's net income is primarily determined by three elements including the expenses related to these elements:

- net premium income
- investment income
- 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

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

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

- general interest rate levels
- 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

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 catastrophic 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 accounting principles generally accepted in the United States of America, 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, 2003 included in the Company's 2003 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.

Liabilities 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

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**Management's Discussion and Analysis of Results
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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 evaluates its investment portfolio quarterly to determine if a decline in fair value below cost is other than temporary. Harleysville Group has written down to fair value, without exception, 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 down if the evaluation indicates the decline is other-than-temporary. The fair value of equity securities is based on the closing market value as reported by a national stock exchange or Nasdaq. The 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.

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

Policy Acquisition Costs. Policy acquisition costs, such as commissions, premium taxes and certain other underwriting and agency expenses that vary with and are directly 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, 2004 and 2003 is discussed in greater detail below.

Results of Operations

Premiums earned increased \$3.5 million and \$15.5 million during the three and nine months ended September 30, 2004, respectively, compared to the same prior year periods. The increases are primarily due to increases in premiums earned for commercial lines of \$8.3 million and \$31.5 million partially offset by decreases of \$4.8 million and \$16.0 million in personal lines premiums earned for the three and nine months ended September 30, 2004, respectively. The increases in premiums earned for commercial lines were 5.1% and 6.8% for the three and nine months ended September 30, 2004, respectively, primarily due to higher rates

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

partially offset by fewer policy counts. The decline in policy counts was primarily in the workers compensation line of business. The declines in premiums earned for personal lines were 10.1% and 10.9% for the three and nine months ended September 30, 2004, 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 decreased \$0.1 million and \$0.2 million for the three and nine months ended September 30, 2004, respectively, compared to the same prior year periods, resulting from a lower yield on the fixed maturity investment portfolio partially offset by an increase in invested assets.

Realized investment gains (losses) improved \$0.6 million for the three months ended September 30, 2004 due to lesser losses on the sale of equity investments, partially offset by lesser gains on the sale of fixed maturity investments. Realized investment gains (losses) improved \$13.5 million for the nine months ended September 30, 2004, primarily resulting from gains on the sale of two equity securities in the first quarter of 2004.

There were impairment charges of \$0.3 million in the three and nine months ended September 30, 2004 and no impairment charges in the same prior year periods. Harleysville Group had gross realized losses of \$1.2 million and \$3.0 million in the nine months ended September 30, 2004 and 2003, respectively, which were from the sales of securities which had not declined by more than 20% below their cost for more than six months at the time of their sale.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

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

Harleysville Group holds securities with unrealized losses at September 30, 2004 as follows:

	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Length of Unrealized Loss</u>	
			<u>Less Than 12 Months</u>	<u>Over 12 Months</u>
			(in thousands)	
Fixed maturities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 54,539	\$ 411	\$ 326	\$ 85
Obligations of states and political subdivisions	65,368	1,052	455	597
Corporate securities	66,593	3,770	731	3,039
Mortgage-backed securities	<u>30,346</u>	<u>278</u>	<u>278</u>	<u> </u>
Total fixed maturities	<u>\$216,846</u>	<u>\$5,511</u>	<u>\$1,790</u>	<u>\$3,721</u>
Equity securities	<u>\$ 22,564</u>	<u>\$1,741</u>	<u>\$1,741</u>	<u>\$ -</u>

Of the total fixed maturity securities with an unrealized loss at September 30, 2004, securities with a fair value of \$131.8 million and an unrealized loss of \$4.6 million are classified as available for sale and are carried at fair value on the balance sheet while securities with a fair value of \$85.0 million and an unrealized loss of \$0.9 million are classified as held to maturity on the balance sheet and are carried at amortized cost.

There are nine positions that comprise the unrealized loss in equity investments at September 30, 2004. While two of these positions have been below cost for more than six months, they have had volatile price movements and have not been significantly 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 future.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

**Management's Discussion and Analysis of Results
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There are \$58.4 million in fixed maturity securities, at amortized cost, that at September 30, 2004, had been below amortized cost for over 12 months. Of the \$3.7 million of unrealized losses on such securities, \$0.8 million relates to securities which carry A or higher debt ratings and have declined in fair value roughly in line with market interest rate changes. The remaining \$2.9 million of unrealized losses are comprised of airline enhanced equipment trust certificates (EETC) as follows:

	<u>Cost</u>	<u>Fair Value</u>	<u>Maturity Dates</u>
	(in thousands)		
American Airlines	\$14,365	\$12,772	2011
United Airlines	6,949	5,616	2010-2012
	<u>\$21,314</u>	<u>\$18,388</u>	

After the events of September 11, 2001, air travel and the value of these airlines' EETC securities declined. 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. At the time of issuance, the collateral was appraised at approximately twice the value of the A tranche EETCs. Recent estimates indicate that in a distressed sale scenario, the value of the collateral would be approximately the same as the EETCs' cost. At September 30, 2004, the American Airlines EETCs carry an investment grade debt rating and the market value of both issues has improved over the past year. Harleysville Group is participating in certain EETC creditor committees and is monitoring developments. It is possible that these EETCs may be written down in the income statement in the future, depending upon developments involving both the issuers and world events which impact the level of air travel.

Income (loss) before income taxes increased \$67.3 million and \$96.7 million for the three and nine months ended September 30, 2004, respectively, compared to the same prior year periods. The increases were primarily due to lesser underwriting losses and greater realized investment gains. The lesser three and nine months underwriting loss was primarily due to lower catastrophe losses, lesser loss severity and a decrease in the provision for insured events in prior years. The net provision for insured events in prior years consists of \$6.1 million and \$9.1 million of adverse development for the three and nine months ended September 30, 2004, respectively, compared to \$55.1 million and \$76.8 million of adverse development for the three and nine months ended September 30, 2003, respectively.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

**Management's Discussion and Analysis of Results
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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 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 106.6% and 106.4% for the three and nine months ended September 30, 2004, respectively, from 137.2% and 119.4% for the three and nine months ended September 30, 2003, respectively. Such decreases were due to improved underwriting results in both commercial lines and personal lines, primarily resulting from the lower loss development and lower catastrophe losses in the 2004 periods.

The statutory combined ratios by line of business for the three and nine months ended September 30, 2004, as compared to the three and nine months ended September 30, 2003, were as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Commercial:				
Automobile	103.8%	131.2%	103.8%	107.8%
Workers compensation	131.2%	203.1%	125.4%	172.4%
Commercial multi-peril	105.8%	134.6%	105.4%	113.3%
Other commercial	103.4%	84.7%	93.5%	82.4%
Total commercial	108.6%	140.1%	106.7%	119.0%
Personal:				
Automobile	113.0%	129.2%	114.0%	120.7%
Homeowners	78.3%	129.8%	91.2%	122.2%
Other personal	88.0%	85.5%	103.8%	107.2%
Total personal	99.0%	127.3%	105.3%	120.7%
Total personal and commercial	106.6%	137.2%	106.4%	119.4%

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

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

The following table presents the liability for unpaid losses and loss settlement expenses by major line of business:

	September 30, 2004	December 31, 2003
	(in thousands)	
Commercial:		
Automobile	\$ 243,009	\$ 228,356
Workers compensation	299,028	294,750
Commercial multi-peril	356,883	320,607
Other commercial	66,233	59,042
Total commercial	965,153	902,755
Personal:		
Automobile	106,579	117,034
Homeowners	38,187	41,264
Other personal	1,714	1,607
Total personal	146,480	159,905
Total personal and commercial	1,111,633	1,062,660
Plus reinsurance recoverables	169,187	157,317
Total liability	\$1,280,820	\$1,219,977

The commercial lines statutory combined ratio decreased to 108.6% and 106.7% for the three and nine months ended September 30, 2004, respectively, from 140.1% and 119.0% for the three and nine months ended September 30, 2003, respectively. The decreases are primarily due to lesser adverse development in the provision for insured events in prior years and lesser catastrophe losses.

The net \$9.1 million provision for insured events in prior years for the nine months ended September 30, 2004 included \$6.1 million in the most recent quarter primarily consisting of \$2.7 million from commercial multi-peril, \$1.1 million from workers compensation and \$2.3 million from other commercial liability lines. The workers compensation development is due to an estimated assessment from the National Workers Compensation Pool to reflect its commutation with a troubled participant. The development in the other lines reflects loss severity that was higher than the adverse trends noted in previous quarters. The adverse development was primarily from accident years 1995, 1996, 2000 and 2001, partially offset by favorable development in the 2003 accident year.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

**Management's Discussion and Analysis of Results
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(Continued)

The \$55.1 million of third quarter adverse development in 2003 in the provision for insured events in prior years was primarily in the following lines: commercial automobile (\$19.1 million), workers compensation (\$17.1 million), commercial multi-peril (\$13.5 million) and personal automobile (\$4.5 million). The remaining \$21.7 million of adverse development in the nine months ended September 30, 2003 was primarily from \$19.9 million of workers compensation adverse development in the first quarter of 2003. Of the nine-month 2003 adverse development, \$67.2 million was attributable to the 1998 to 2002 accident years and the balance was attributable to other accident years.

The adverse development in workers compensation for the nine months ended September 30, 2003 was \$37.0 million. Harleysville Group had publicly noted adverse loss trends in its workers compensation line for several quarters during 2002 and 2003. These trends are consistent with the experience of other companies writing this coverage, many of which have, during the past two years, made substantial additions to their reserves for insured events in prior years in this line of insurance. The change in loss development patterns in 2003 was influenced by a number of factors. The reorganization of Harleysville Group's claims operations resulted in more proactive claims management which, in turn, provided more contemporaneous loss estimates. In addition, weak economic conditions have hampered the ability to return injured workers to employment thus extending the estimated length of disabilities and medical loss cost trends have increased.

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, 2004</u>	<u>For the year ended December 31, 2003</u>
	(dollars in thousands)	
Number of claims pending, beginning of period	8,005	8,900
Number of claims reported	8,187	12,952
Number of claims settled or dismissed	<u>(8,874)</u>	<u>(13,847)</u>
Number of claims pending, end of period	<u>7,318</u>	<u>8,005</u>
Losses paid	\$55,361	\$ 82,003
Loss settlement expenses paid	\$11,850	\$ 16,465

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

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.

For the nine months ended September 30, 2003, the adverse development in commercial and personal automobile primarily was due to higher loss severity trends that became evident in the third quarter when case reserve increases were recognized. The case reserve increases for commercial automobile primarily related to adverse legal judgments. Harleysville Group had previously publicly noted an increase in litigation on bodily injury cases and a slowing of the rate of settlement. The combination of all of these factors resulted in the increased estimate of ultimate losses.

For the nine months ended September 30, 2003, the adverse development in commercial multi-peril primarily was due to higher loss severity trends that became evident in the third quarter when case reserve increases were recognized. Like commercial auto, the trend of increased litigation and a slowing rate of settlement resulted in the increased estimate of ultimate losses. While Harleysville Group had only incurred \$1.5 million of construction defect liability losses over the past 10 years, it increased its provision for insured events in prior years by an additional \$1.4 million in the third quarter of 2003 for estimated losses on construction defect liability claims because of increased case activity in that quarter.

Harleysville Group records the actuarial best estimate of the ultimate unpaid losses and loss settlement expenses incurred and does not determine an estimated possible range of loss. Actuarial loss reserving techniques and assumptions, which rely on historical information as adjusted to reflect current conditions, have been consistently applied 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.

Because of the nature of insurance claims, there are uncertainties inherent in the estimates of ultimate losses. The aforementioned reorganization of the claims operation has resulted in new people and processes involved in settling claims.

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

As a result, more recent statistical data reflects different patterns than in the past and give rise to uncertainty as to the pattern of future loss settlements. Litigation on bodily injury liability cases has increased during the past two years while the rate of settlement has slowed. These changed patterns give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury liability claims. 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, 2004. For every 1% change in the aggregate estimate across all lines, the effect on pre-tax income would be \$11.1 million.

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 incurred significant losses from such claims.

The personal lines statutory combined ratio decreased to 99.0% and 105.3% for the three and nine months ended September 30, 2004 from 127.3% and 120.7% for the three and nine months ended September 30, 2003. The decreases primarily were due to generally lower loss frequency and lesser catastrophe losses which affected the homeowners line.

Net catastrophe losses decreased \$4.4 million and \$7.7 million and losses ceded under the aggregate catastrophe reinsurance agreement with Mutual decreased \$0.3 million and \$4.1 million for the three and nine months ended September 30, 2004, respectively, primarily due to less severe catastrophes in the 2004 periods. The three months ended September 30, 2004 includes \$6.1 million of losses from weather related catastrophes, primarily four hurricanes. The three months ended September 30, 2003 includes \$9.4 million of losses from Hurricane Isabel.

The income tax expense for the three and nine months ended September 30, 2004 includes the tax benefit of \$2.6 million and \$8.0 million associated with tax-exempt income compared to \$2.6 million and \$7.7 million in the same prior year periods.

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

Other expenses increased \$1.2 million for the three months ended September 30, 2004 primarily due to the write-off of capitalized costs for a software project that will not be completed.

The insurance industry has recently received adverse publicity about alleged anti-competitive activities by certain insurance brokers and insurers. Harleysville Group primarily distributes its products through its agents and writes less than 1% of its premiums through brokers. There are no contingent commission arrangements with such brokers.

Liquidity and Capital Resources

Operating activities provided \$70.2 million and \$113.3 million of net cash for the nine months ended September 30, 2004 and 2003, respectively. The change primarily is from lesser underwriting cash flow.

Investing activities used \$70.4 million and \$196.9 million of net cash for the nine months ended September 30, 2004 and 2003, respectively. The decrease is primarily due to a decrease in net purchases of fixed maturity investments due to the decrease in cash provided by operations and by the change in cash provided by financing activities.

Financing activities used \$12.2 million of net cash for the nine months ended September 30, 2004, compared to net cash provided of \$85.2 million in the same prior year period. The change is primarily due to the issuance of debt in the 2003 period.

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, 2004, Harleysville Group held cash collateral of \$120.9 million related to securities on loan with a market value of \$117.1 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

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

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 \$11.1 million of cash and marketable securities at September 30, 2004 which is available for general corporate purposes including dividends, debt service, capital contributions to subsidiaries, acquisitions and the repurchase of stock. Harleysville Group has adopted a stock repurchase plan under which it may, from time to time, repurchase up to 500,000 shares of Harleysville Group Inc. common stock. Mutual has authorized purchases of the common shares of Harleysville Group in an equal amount. As of September 30, 2004, the Company had repurchased 397,909 shares leaving 102,091 shares authorized to be repurchased. The Company has no other material commitments for capital expenditures as of September 30, 2004.

Risk Factors

The business, results of operations and financial condition, and therefore the value of the 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 2003, filed with the Securities and Exchange Commission on March 12, 2004.

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, 2003 to September 30, 2004. In addition, the Company has not significantly changed its investment mix or market risk during this period.

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

- (a) Evaluation of disclosure controls and procedures. The Company's chief executive officer and its chief financial officer, based on their evaluation of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) have concluded that the Company's disclosure controls and procedures are adequate and effective for the purposes set forth in the definition thereof in Exchange Act Rule 13a-15(e) as of September 30, 2004.
- (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 2004 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting except as noted in the next paragraph.

During 2003, the Company reviewed the processes by which case reserves for loss and loss settlement expenses are estimated and whether those processes were being consistently applied. These processes are an important element in establishing aggregate reserves. Management took steps in 2003 to improve internal controls in this area, including hiring a new Senior Vice President to manage the claims function, reducing turnover rates in the personnel engaged in estimating case reserves and proactively managing the effects of such turnover, implementing refinements in the processes which the Company follows in estimating these reserves, and shifting the internal audit of compliance with these processes from an internal auditor within the claims department to the Company's regular internal audit group. Management expects the effectiveness of these internal controls to continue to improve in 2004 as a result of these actions and, as part of our normal actuarial review process, will evaluate the impact of these changes on a regular basis.

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

Item 1. Legal Proceedings - None

Item 2. Unregistered Sales of Equity Securities

(c) The Company announced a stock repurchase plan on March 3, 2003. The Company may purchase up to 500,000 shares of Harleysville Group Inc. common stock. The plan expires February 26, 2005. As of September 30, 2004, the Company had repurchased 397,909 shares leaving 102,091 shares authorized to be repurchased. There was no activity in the plan during the nine months ended September 30, 2004.

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

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Exchange Act.

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Exchange Act.

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b. Reports on Form 8-K

A Form 8-K dated July 29, 2004 was filed furnishing, under item 12 of Form 8-K, financial results for the second quarter of 2004.

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

(Continued)

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 3, 2004

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

**CERTIFICATION PURSUANT TO THE SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Michael L. Browne, certify that:

1. I have reviewed the quarterly report on Form 10-Q of Harleysville Group Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial conditions, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2004

/s/ MICHAEL L. BROWNE
Michael L. Browne
Chief Executive Officer and a Director

Exhibit (31.2)**CERTIFICATION PURSUANT TO THE SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Bruce J. Magee, certify that:

1. I have reviewed the quarterly report on Form 10-Q of Harleysville Group Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial conditions, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2004

/s/ BRUCE J. MAGEE
Bruce J. Magee
Senior Vice President and
Chief Financial Officer

Exhibit (32.1)

HARLEYSVILLE GROUP INC.

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Harleysville Group Inc. (the "Company") on Form 10-Q for the period ended September 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael L. Browne, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that based on my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 3, 2004

/s/ MICHAEL L. BROWNE
Michael L. Browne
Chief Executive Officer and a Director

Exhibit (32.2)

HARLEYSVILLE GROUP INC.

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Harleysville Group Inc. (the "Company") on Form 10-Q for the period ended September 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Bruce J. Magee, Senior Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that based on my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 3, 2004

/s/ BRUCE J. MAGEE
Bruce J. Magee
Senior Vice President and
Chief Financial Officer

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