

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

FORM 10-Q

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from _____ to _____

Commission file number 0-14697

HARLEYSVILLE GROUP INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

51-0241172

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

355 Maple Avenue, Harleysville, PA 19438-2297

(Address of principal executive offices) (Zip Code)

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

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No .

At May 2, 2005 30,320,636 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>March 31,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
	(Unaudited)	
Assets		
Investments:		
Fixed maturities:		
Held to maturity, at amortized cost (fair value \$501,188 and \$517,434)	\$ 492,260	\$ 499,487
Available for sale, at fair value (cost \$1,086,565 and \$1,028,457)	1,106,630	1,067,504
Equity securities, at fair value (cost \$112,034 and \$110,495)	148,975	150,249
Short-term investments, at cost, which approximates fair value	75,347	113,822
Fixed maturity securities on loan:		
Held to maturity, at amortized cost (fair value \$967 and \$1,966)	917	1,835
Available for sale, at fair value (amortized cost \$130,837 and \$128,183)	134,761	134,020
Total investments	<u>1,958,890</u>	<u>1,966,917</u>
Cash	2,893	328
Receivables:		
Premiums	139,335	141,601
Reinsurance (affiliate \$372 and \$390)	182,872	193,209
Accrued investment income	21,990	23,236
Total receivables	<u>344,197</u>	<u>358,046</u>
Deferred policy acquisition costs	102,271	100,755
Prepaid reinsurance premiums	32,331	32,675
Property and equipment, net	18,488	20,891
Deferred income taxes	62,065	53,137
Securities lending collateral	139,226	139,486
Other assets	44,740	45,828
Total assets	<u>\$ 2,705,101</u>	<u>\$ 2,718,063</u>
Liabilities and Shareholders' Equity		
Liabilities:		
Unpaid losses and loss settlement expenses (affiliate \$184,464 and \$187,172)	\$ 1,343,517	\$ 1,317,735
Unearned premiums (affiliate \$52,705 and \$47,038)	445,088	441,697
Accounts payable and accrued expenses	76,481	99,098
Securities lending obligation	139,226	139,486
Debt (affiliate \$18,500 and \$18,500)	119,625	119,625
Due to affiliate	277	12,498
Total liabilities	<u>2,124,214</u>	<u>2,130,139</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 31,704,753 and 31,589,474 shares; outstanding 30,306,844 and 30,191,565 shares	31,705	31,589
Additional paid-in capital	163,608	161,689
Accumulated other comprehensive income	26,641	42,051
Retained earnings	384,113	377,282
Deferred compensation	(693)	(200)
Treasury stock, at cost, 1,397,909 shares	(24,487)	(24,487)
Total shareholders' equity	<u>580,887</u>	<u>587,924</u>
Total liabilities and shareholders' equity	<u>\$ 2,705,101</u>	<u>\$ 2,718,063</u>

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

For the three months ended March 31, 2005 and 2004

(dollars in thousands, except per share data)

	<u>2005</u>	<u>2004</u>
Revenues:		
Premiums earned from affiliate, (ceded to affiliate, \$183,450 and \$181,176)	\$ 206,680	\$ 206,948
Investment income, net of investment expense	21,761	21,642
Realized investment gains		12,488
Other income (affiliate \$1,793 and \$1,775)	<u>4,283</u>	<u>4,564</u>
Total revenues	<u>232,724</u>	<u>245,642</u>
Losses and expenses:		
Losses and loss settlement expenses (ceded to affiliate, \$132,020 and \$139,685)	147,868	151,110
Amortization of deferred policy acquisition costs	50,918	50,688
Other underwriting expenses	16,355	19,638
Interest expense (affiliate \$131 and \$84)	1,620	1,577
Other expenses	<u>1,507</u>	<u>1,419</u>
Total expenses	<u>218,268</u>	<u>224,432</u>
Income before income taxes	14,456	21,210
Income taxes	<u>2,474</u>	<u>4,717</u>
Net income	<u>\$ 11,982</u>	<u>\$ 16,493</u>
Per common share:		
Basic earnings	<u>\$.40</u>	<u>\$.55</u>
Diluted earnings	<u>\$.39</u>	<u>\$.55</u>
Cash dividend	<u>\$.17</u>	<u>\$.17</u>

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(Unaudited)
For the three months ended March 31, 2005
(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 at December 31, 2004	31,589,474	\$ 31,589	\$ 161,689	\$ 42,051	\$ 377,282	\$ (200)	\$ (24,487)	\$ 587,924
Net income					11,982			11,982
Other comprehensive income, net of tax:								
Unrealized investment losses, net of reclassification adjustment				(15,410)				(15,410)
Comprehensive loss								(3,428)
Issuance of common stock	115,279	116	1,838					1,954
Tax benefit from stock options exercised			81					81
Deferred compensation						(493)		(493)
Cash dividend paid					(5,151)			(5,151)
Balance at March 31, 2005	<u>31,704,753</u>	<u>\$ 31,705</u>	<u>\$ 163,608</u>	<u>\$ 26,641</u>	<u>\$ 384,113</u>	<u>\$ (693)</u>	<u>\$ (24,487)</u>	<u>\$ 580,887</u>

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP INC AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
For the three months ended March 31, 2005 and 2004
(in thousands)

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Net income	\$ 11,982	\$ 16,493
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in receivables, unearned premiums, prepaid reinsurance balances	17,584	(9,820)
Change in affiliate balance	(12,221)	(12,857)
Increase in unpaid losses and loss settlement expenses	25,782	31,900
Deferred income taxes	(631)	804
(Increase) decrease in deferred policy acquisition costs	(1,516)	149
Amortization and depreciation	1,401	1,406
Gain on sale of investments		(12,488)
Other, net	<u>(12,748)</u>	<u>(4,393)</u>
Net cash provided by operating activities	<u>29,633</u>	<u>11,194</u>
Cash flows from investing activities:		
Fixed maturity investments:		
Purchases	(98,560)	(43,304)
Sales or maturities	36,074	54,690
Equity securities:		
Purchases	(1,539)	(7,096)
Sales		14,183
Net sales (purchases) of short-term investments	38,475	(37,280)
Sale (purchase) of property and equipment	<u>1,851</u>	<u>(195)</u>
Net cash used by investing activities	<u>(23,699)</u>	<u>(19,002)</u>
Cash flows from financing activities:		
Issuance of common stock	1,782	1,259
Dividends paid (to affiliate, \$2,890 and \$2,890)	<u>(5,151)</u>	<u>(5,099)</u>
Net cash used by financing activities	<u>(3,369)</u>	<u>(3,840)</u>
Increase (decrease) in cash	2,565	(11,648)
Cash at beginning of period	<u>328</u>	<u>13,430</u>
Cash at end of period	<u>\$ 2,893</u>	<u>\$ 1,782</u>

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 - Basis of Presentation

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

These financial statements should be read in conjunction with the financial statements and notes for the year ended December 31, 2004 included in the Company's 2004 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 its subsidiaries.

Policy Acquisition Costs

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

Stock-Based Compensation

Stock-based compensation plans are accounted for under the provisions of Accounting Principles Board (APB) Opinion No. 25, "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 months ended March 31, 2005 and 2004:

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

	For the three months ended March 31,	
	<u>2005</u>	<u>2004</u>
	(in thousands, except per share data)	
Net income, as reported	\$ 11,982	\$ 16,493
Plus:		
Stock-based employee compensation expense (benefit) included in reported net income, net of related tax effects	(270)	43
Less:		
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(212)</u>	<u>(749)</u>
Pro forma net income	<u>\$ 11,500</u>	<u>\$ 15,787</u>
Basic earnings per share:		
As reported	\$.40	\$.55
Pro forma	\$.38	\$.53
Diluted earnings per share:		
As reported	\$.39	\$.55
Pro forma	\$.38	\$.53

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R), "Share-Based Payment," which is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS 123(R) requires that the compensation cost related to share-based payment transactions be recognized in financial statements. The compensation cost will be measured based on the fair value of the equity or liability instruments issued. The Statement is effective as of the beginning of the first fiscal year beginning after June 15, 2005. The impact of adopting SFAS No. 123(R) on net income and earnings per share is not currently expected to be materially different from the pro forma amounts disclosed above which includes all share-based payment transactions through March 31, 2005. The impact that any future share-based payment transactions will have on our financial position or results of operations is not yet known.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

2 - Earnings Per Share

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

	For the three months ended March 31,	
	<u>2005</u>	<u>2004</u>
	(in thousands, except per share data)	
Numerator for basic and diluted earnings per share:		
Net income	\$ <u>11,982</u>	\$ <u>16,493</u>
Denominator for basic earnings per share--weighted average shares outstanding	30,253,967	29,960,760
Effect of stock incentive plans	<u>145,379</u>	<u>87,375</u>
Denominator for diluted earnings per share	<u>30,399,346</u>	<u>30,048,135</u>
Basic earnings per share:	\$ <u>.40</u>	\$ <u>.55</u>
Diluted earnings per share:	\$ <u>.39</u>	\$ <u>.55</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 March 31,	
	<u>2005</u>	<u>2004</u>
	(in thousands)	
Number of options	<u>1,298</u>	<u>1,413</u>

3 – Reinsurance

Premiums earned are net of amounts ceded of \$21,909,000 and \$21,578,000 for the three months ended March 31, 2005 and 2004, respectively. Losses and loss settlement expenses are net of amounts ceded of \$7,674,000 and \$34,154,000 for the three months ended March 31, 2005 and 2004, respectively. Such amounts do not include the reinsurance transactions with Mutual under the pooling arrangement.

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

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

earthquakes, terrorism or hurricanes, and supplements the existing external catastrophe reinsurance program. Under the agreement, Harleysville Group ceded premiums earned of \$2,075,000 and \$1,997,000 and losses incurred of \$61,000 and \$1,800,000 to Mutual for the three months ended March 31, 2005 and 2004, 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 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

There were no cash tax payments in the first quarter of 2005. Cash tax refunds of \$3,798,000 were received in the first quarter of 2004. Cash interest payments of \$3,006,000 and \$2,974,000 were made in the first quarter of 2005 and 2004, 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).

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

Financial data by segment is as follows:

	For the three months ended March 31,	
	<u>2005</u>	<u>2004</u>
	(in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	\$ 167,313	\$ 162,320
Personal lines	<u>39,367</u>	<u>44,628</u>
Total premiums earned	206,680	206,948
Net investment income	21,761	21,642
Realized investment gains		12,488
Other	<u>4,283</u>	<u>4,564</u>
Total revenues	<u>\$ 232,724</u>	<u>\$ 245,642</u>
Income before income taxes:		
Underwriting income (loss):		
Commercial lines	\$ (10,238)	\$ (9,648)
Personal lines	<u>417</u>	<u>(4,860)</u>
SAP underwriting loss	(9,821)	(14,508)
GAAP adjustments	<u>1,360</u>	<u>20</u>
GAAP underwriting loss	(8,461)	(14,488)
Net investment income	21,761	21,642
Realized investment gains		12,488
Other	<u>1,156</u>	<u>1,568</u>
Income before income taxes	<u>\$ 14,456</u>	<u>\$ 21,210</u>

6 - Comprehensive Income

Comprehensive income for the three months ended March 31, 2005 and 2004 consisted of the following (all amounts are net of taxes):

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

	For the three months ended March 31,	
	<u>2005</u>	<u>2004</u>
	(in thousands)	
Net income	\$ 11,982	\$ 16,493
Other comprehensive income (loss):		
Unrealized investment holding gains (losses) arising during period	(15,410)	10,721
Less:		
Reclassification adjustment for gains included in net income		(8,093)
Net unrealized investment gains (losses)	<u>(15,410)</u>	<u>2,628</u>
Comprehensive income (loss)	<u>\$ (3,428)</u>	<u>\$ 19,121</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:

	For the three months ended March 31,	
	<u>2005</u>	<u>2004</u>
	(in thousands)	
Components of net periodic pension cost:		
Service cost	\$ 2,209	\$ 1,993
Interest cost	2,988	2,770
Expected return on plan assets	(2,790)	(3,020)
Recognized net actuarial loss	1,112	518
Amortization of prior service cost	52	52
Net transition amortization	<u>13</u>	<u>12</u>
Net periodic pension cost:		
Entire plan	<u>\$ 3,584</u>	<u>\$ 2,325</u>
Harleysville Group portion	<u>\$ 2,375</u>	<u>\$ 1,533</u>

Harleysville Group's expected portion of the 2005 contribution to the pension plan is \$8,015,000. Contributions of \$1,999,000 were made in the quarter ended March 31, 2005.

8 – Shareholders' Equity

Various states have adopted the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) standards that require insurance companies to calculate and report

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

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 2004 statutory financial statements, the ratio of total adjusted capital to the Authorized Control Level for the Company's nine insurance subsidiaries at December 31, 2004 ranged from 498% to 609%.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

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

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

Overview

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

- net premium income
- investment income
- 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 Financial Condition and Results of Operations

(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 catastrophe losses
- the availability, cost and terms of reinsurance
- underlying settlement costs, including medical and legal costs

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

Critical Accounting Policies and Estimates

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles, which require Harleysville Group to make estimates and assumptions (see Note 1 of the Notes to Consolidated Financial Statements for the year ended December 31, 2004 included in the Company's 2004 Annual Report filed with the Securities and Exchange Commission on Form 10-K). Harleysville Group believes that of its significant accounting policies, the following may involve a higher degree of judgment and estimation. The judgments, or the methodology on which the judgments are made, are reviewed quarterly with the Audit Committee.

Liability for Losses and Loss Settlement Expenses. The liability for losses and loss settlement expenses represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims which have not yet been reported to Harleysville Group. The amount of loss reserves for reported claims is based primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amounts of loss reserves for unreported claims and loss

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

(Continued)

settlement expense reserves are determined utilizing historical information by line of insurance as adjusted to current conditions. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results. Reserves are closely monitored and are recomputed periodically using the most recent information on reported claims and a variety of statistical techniques. It is expected that such estimates will be more or less than the amounts ultimately paid when the claims are settled. Changes in these estimates are reflected in current operations.

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

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

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

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

(Continued)

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 March 31, 2005 and 2004 is discussed in greater detail below.

Results of Operations

Premiums earned decreased \$0.3 million during the three months ended March 31, 2005 as compared to the three months ended March 31, 2004. The decrease is primarily due to a decrease of \$5.3 million in premiums earned for personal lines partially offset by an increase of \$5.0 million in commercial lines premiums earned. The decline in premiums earned for personal lines was 11.8%, primarily due to fewer policy counts. The reduction in personal lines volume was driven primarily by a reduction in personal automobile business from the continued implementation of more stringent underwriting processes. The increase in premiums earned for commercial lines was 3.1%, primarily due to higher rates.

Investment income increased \$0.1 million for the three months ended March 31, 2005 primarily due to a higher level of invested assets partially offset by a lower yield on the fixed maturity investment portfolio.

Realized investment gains decreased \$12.5 million for the three months ended March 31, 2005 compared to the same prior year quarter. There were no sales of investment securities in the first quarter of 2005. The decrease primarily resulted from gains on the sale of two equity securities in the first quarter of 2004.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

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

Harleysville Group holds securities with unrealized losses at March 31, 2005 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	\$ 137,221	\$ 2,244	\$ 2,127	\$ 117
Obligations of states and political subdivisions	169,601	3,244	2,042	1,202
Corporate securities	228,423	6,085	3,832	2,253
Mortgage-backed securities	43,212	447	447	
Total fixed maturities	<u>\$ 578,457</u>	<u>\$ 12,020</u>	<u>\$ 8,448</u>	<u>\$ 3,572</u>
Equity securities	<u>\$ 18,495</u>	<u>\$ 2,021</u>	<u>\$ 2,021</u>	<u>\$</u>

There are eleven positions that comprise the unrealized loss in equity investments at March 31, 2005. All 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 income statement in the future.

Of the total fixed maturity securities with an unrealized loss at March 31, 2005, securities with a fair value of \$412.3 million and an unrealized loss of \$8.6 million are classified as available for sale and are carried at fair value on the balance sheet while securities with a fair value of \$166.2 million and an unrealized loss of \$3.4 million are classified as held to maturity on the balance sheet and are carried at amortized cost.

The fixed maturity investments with continuous unrealized losses for less than twelve months were primarily due to the impact of higher market interest rates rather than a decline in credit quality. There are \$69.6 million in fixed maturity securities, at fair value, that at March 31, 2005, had been below amortized cost for over twelve months. Of the \$3.6 million of unrealized losses on such securities, \$1.9 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 \$1.7 million of unrealized losses are comprised of airline enhanced equipment trust certificates (EETC) as follows:

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

Management's Discussion and Analysis of Financial Condition and Results of Operations

(Continued)

	Cost	Fair Value <small>(in thousands)</small>	Maturity Dates
American Airlines	\$ 14,367	\$ 13,385	2011
United Airlines	6,933	6,344	2010-2012
Other airlines	2,000	1,892	2011
	\$ 23,300	\$ 21,621	

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. The EETCs' market value 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.

In the first quarter of 2005, Harleysville Group had income before income taxes of \$14.5 million, compared to \$21.2 million in the first quarter of 2004. The decrease in income before income taxes of \$6.8 million for the three months ended March 31, 2005, as compared to the same period in 2004, was primarily due to the decreased realized investment gains, partially offset by improved underwriting results. The improved underwriting results in 2005 primarily were due to lesser loss severity, lesser catastrophe losses and lower expenses. Other underwriting expenses declined \$3.3 million primarily due to a lower number of employees. Catastrophe losses were \$ 1.0 million and \$2.6 million for the three months ended March 31, 2005 and 2004, respectively.

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 104.2% for the three months ended March 31, 2005 from 107.2% for the three months ended March 31, 2004. Such decrease was due to better underwriting results in both commercial lines and personal lines.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

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

The statutory combined ratios by line of business for the three months ended March 31, 2005, as compared to the three months ended March 31, 2004, were as follows:

	For the three months ended March 31,	
	2005	2004
Commercial:		
Automobile	100.1%	103.1%
Workers compensation	125.7%	122.9%
Commercial multi-peril	105.2%	105.1%
Other commercial	84.9%	81.7%
Total commercial	104.3%	104.7%
Personal:		
Automobile	106.1%	118.3%
Homeowners	102.9%	109.3%
Other personal	87.8%	147.6%
Total personal	103.7%	116.2%
Total personal and commercial	104.2%	107.2%

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

	March 31, 2005	December 31, 2004
	(in thousands)	
Commercial:		
Automobile	\$ 258,322	\$ 249,044
Workers compensation	302,314	298,994
Commercial multi-peril	392,343	371,247
Other commercial	74,194	70,535
Total commercial	1,027,173	989,820
Personal:		
Automobile	100,836	103,050
Homeowners	38,312	37,026
Other personal	1,754	1,713
Total personal	140,902	141,789
Total personal and commercial	1,168,075	1,131,609
Plus reinsurance recoverables	175,442	186,126
Total liability	\$ 1,343,517	\$ 1,317,735

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

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

The commercial lines statutory combined ratio decreased to 104.3% for the three months ended March 31, 2005 from 104.7% for the three months ended March 31, 2004. The decrease is primarily due to a decrease in the combined ratio for commercial automobile primarily due to lower loss severity.

There was \$6.0 million of net favorable development in the provision for insured events in prior years for the three months ended March 31, 2005 of which \$3.7 million was in commercial lines and \$2.3 million was in personal lines. Approximately half of the favorable development related to the liability for loss adjusting expenses. The remaining favorable development primarily related to the 2004 accident year in the property lines partially offset by adverse development in prior accident years.

There was \$0.6 million of net favorable development in the provision for insured events in prior years for the three months ended March 31, 2004. This was net of \$3.1 million of adverse development in commercial automobile which was more than offset by favorable development in other lines.

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:

	For the three months ended March 31, 2005	For the year ended December 31, 2004
	(dollars in thousands)	
Number of claims pending, beginning of period	6,832	8,005
Number of claims reported	2,213	10,632
Number of claims settled or dismissed	(2,354)	(11,805)
Number of claims pending, end of period	6,691	6,832
Losses paid	\$ 16,470	\$ 73,548
Loss settlement expenses paid	\$ 3,738	\$ 15,831

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

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

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

(Continued)

Because of the nature of insurance claims, there are uncertainties inherent in the estimates of ultimate losses. Reorganization of the claims operation in recent years has resulted in new people and processes involved in settling claims. As a result, more recent statistical data reflects different patterns than in the past and gives rise to uncertainty as to the pattern of future loss settlements. Litigation on bodily injury liability cases is higher for the past three years while the rate of settlement is slower. The slowing rate of settlement began to stabilize in 2004. 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 March 31, 2005. For every 1% change in the estimate, the effect on pre-tax income would be \$11.7 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 experienced significant losses from such claims.

The personal lines statutory combined ratio decreased to 103.7% for the three months ended March 31, 2005 from 116.2% for the three months ended March 31, 2004. The decrease primarily was due to lesser catastrophe losses which affected the homeowners line, and lower loss severity in personal automobile.

Net catastrophe losses decreased \$1.6 million and losses ceded under the aggregate catastrophe reinsurance agreement with Mutual decreased \$1.7 million for the three months ended March 31, 2005, due to less severe catastrophes in the 2005 period.

The income tax expense for each of the three month periods ended March 31, 2005 and 2004 includes a tax benefit of \$2.6 million and \$2.7 million, respectively, related to tax-exempt investment income.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

Management's Discussion and Analysis of Financial Condition and Results of Operations

(Continued)

Liquidity and Capital Resources

Operating activities provided \$29.6 million and \$11.2 million of net cash for the three months ended March 31, 2005 and 2004, respectively. The change primarily is from an increase in net cash provided by underwriting activities.

Investing activities used \$23.7 million and \$19.0 million of net cash for the three months ended March 31, 2005 and 2004, respectively. The increase is primarily due to an increase in net purchases of fixed maturity investments, partially offset by a decrease in the purchase of short-term investments.

Financing activities used \$3.4 million and \$3.8 million of net cash for the three months ended March 31, 2005 and 2004, respectively. The change is primarily due to an increase in the issuance of common stock.

Harleysville Group participates in a securities lending program whereby certain fixed maturity securities from the investment portfolio are loaned to other institutions for a short period of time in return for a fee. At March 31, 2005, Harleysville Group held cash collateral of \$139.2 million related to securities on loan with a market value of \$135.7 million. Harleysville Group's policy is to require initial collateral of 102% of the market value of loaned securities plus accrued interest, which is required to be maintained daily by the borrower at no less than 100% of such market value plus accrued interest over the life of the loan. Acceptable collateral includes cash and money market instruments, government securities, A-rated corporate obligations, AAA-rated asset-backed securities or GIC's and Funding Agreements from issuers rated A or better. The securities on loan to others have been segregated from the other invested assets on the balance sheet. In addition, the assets and liabilities have been grossed up to reflect the collateral held under the securities lending program and the obligation to return this collateral upon the return of the loaned securities.

Harleysville Group Inc. had \$17.5 million of cash and marketable securities at March 31, 2005 which is available for general corporate purposes including dividends, debt service, capital contributions to subsidiaries, acquisitions and the repurchase of stock. The Company has no material commitments for capital expenditures as of March 31, 2005.

RISK FACTORS

The business, results of operations and financial condition, and therefore the value of Harleysville Group's securities, are subject to a number of risks. Some of those risks are set forth in the Company's annual report on Form 10-K for fiscal year 2004, filed with the Securities and Exchange Commission on March 14, 2005.

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

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

Harleysville Group has maintained approximately the same duration of its investment portfolio to its liabilities from December 31, 2004 to March 31, 2005. In addition, the Company has maintained approximately the same investment mix during this period.

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

- (a) Evaluation of disclosure controls and procedures. Our management, under the supervision and with the participation of the chief executive officer and the chief financial officer, has evaluated the effectiveness of our controls and procedures related to our reporting and disclosure obligations as of March 31, 2005, which is the end of the period covered by this quarterly report on Form 10-Q. Based on that evaluation, the chief executive officer and chief financial officer have concluded that these disclosure controls and procedures are sufficient to provide that (a) material information relating to us, including our consolidated subsidiaries, is made known to these officers by other employees of us and our consolidated subsidiaries, particularly material information related to the period for which this periodic report is being prepared; and (b) this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the rules and forms of the Securities and Exchange Commission.

- (b) Change in internal control over financial reporting. There was no change in the Company's internal control over financial reporting that occurred during the first quarter of 2005 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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

ITEM 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.

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: May 4, 2005

By: /s/ ARTHUR E. CHANDLER

Arthur E. Chandler
Senior Vice President and
Chief Financial Officer
(principal financial 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) 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
 - d) 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: May 4, 2005

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

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

I, Arthur E. Chandler, 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) 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
 - d) 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: May 4, 2005

/s/ ARTHUR E. CHANDLER
Arthur E. Chandler
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 Harleystville Group Inc. (the "Company") on Form 10-Q for the period ended March 31, 2005, 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: May 4, 2005

/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 March 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Arthur E. Chandler, 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: May 4, 2005

/s/ ARTHUR E. CHANDLER
Arthur E. Chandler
Senior Vice President and
Chief Financial Officer