

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, 2002 .

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 .

At November 1, 2002, 29,901,945 shares of common stock of Harleysville Group Inc. were outstanding.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**INDEX**

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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>2002</u> | <u>December 31,</u> <u>2001</u> |
|---|-------------------------------------|------------------------------------|
| | (Unaudited) | |
| <u>Assets</u> | | |
| Investments: | | |
| Fixed maturities: | | |
| Held to maturity, at amortized cost (fair value \$432,247 and \$459,588) | \$ 398,902 | \$ 439,499 |
| Available for sale, at fair value (amortized cost \$889,332 and \$956,047) | 958,555 | 984,264 |
| Equity securities, at fair value (cost \$90,591 and \$110,803) | 92,094 | 150,686 |
| Short-term investments, at cost, which approximates fair value | 72,052 | 36,695 |
| Fixed maturity securities on loan | | |
| Held to maturity, at amortized cost (fair value \$9,090) | 8,357 | |
| Available for sale, at fair value (amortized cost \$117,484) | <u>127,824</u> | |
| Total investments | 1,657,784 | 1,611,144 |
| Cash | 2,665 | 1,839 |
| Receivables: | | |
| Premiums | 141,408 | 122,508 |
| Reinsurance | 78,675 | 81,640 |
| Accrued investment income | <u>20,603</u> | <u>21,862</u> |
| Total receivables | 240,686 | 226,010 |
| Deferred policy acquisition costs | 94,747 | 86,076 |
| Prepaid reinsurance premiums | 21,405 | 20,096 |
| Property and equipment, net | 27,767 | 28,873 |
| Deferred income taxes | 26,553 | 29,435 |
| Securities lending collateral | 147,900 | |
| Due from affiliate | 13,452 | |
| Other assets | <u>67,249</u> | <u>41,817</u> |
| Total assets | <u>\$2,300,208</u> | <u>\$2,045,290</u> |
| <u>Liabilities and Shareholders' Equity</u> | | |
| Liabilities: | | |
| Unpaid losses and loss settlement expenses | \$ 916,170 | \$ 879,056 |
| Unearned premiums | 415,038 | 373,737 |
| Accounts payable and accrued expenses | 102,932 | 96,440 |
| Securities lending obligation | 147,900 | |
| Debt | 95,620 | 96,055 |
| Due to affiliate | | <u>9,704</u> |
| Total liabilities | <u>1,677,660</u> | <u>1,454,992</u> |
| Shareholders' equity: | | |
| Preferred stock, \$1 par value, authorized 1,000,000 shares; none issued | | |
| Common stock, \$1 par value, authorized 80,000,000 shares; issued 30,882,000 and 30,444,678 shares; outstanding 29,882,000 and 29,444,678 shares | 30,882 | 30,445 |
| Additional paid-in capital | 148,423 | 140,065 |
| Accumulated other comprehensive income | 52,693 | 44,265 |
| Retained earnings | 406,115 | 391,088 |
| Treasury stock, at cost, 1,000,000 shares | <u>(15,565)</u> | <u>(15,565)</u> |
| Total shareholders' equity | <u>622,548</u> | <u>590,298</u> |
| Total liabilities and shareholders' equity | <u>\$2,300,208</u> | <u>\$2,045,290</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, 2002 and 2001
(dollars in thousands, except per share data)

| | <u>2002</u> | <u>2001</u> |
|--|------------------|-----------------|
| Revenues: | | |
| Premiums earned | \$196,524 | \$184,804 |
| Investment income, net of investment expenses | 21,739 | 21,388 |
| Realized investment gains (losses) | 57 | (4,154) |
| Other income | <u>3,967</u> | <u>3,783</u> |
| Total revenues | <u>222,287</u> | <u>205,821</u> |
| Losses and expenses: | | |
| Losses and loss settlement expenses | 134,708 | 134,275 |
| Amortization of deferred policy acquisition costs | 47,375 | 44,839 |
| Other underwriting expenses | 17,878 | 15,561 |
| Interest expense | 1,423 | 1,515 |
| Other expenses | <u>1,178</u> | <u>1,206</u> |
| Total expenses | <u>202,562</u> | <u>197,396</u> |
| Income before income taxes | 19,725 | 8,425 |
| Income taxes | <u>4,509</u> | <u>570</u> |
| Net income | <u>\$ 15,216</u> | <u>\$ 7,855</u> |
| Per common share: | | |
| Basic earnings | <u>\$.51</u> | <u>\$.27</u> |
| Diluted earnings | <u>\$.50</u> | <u>\$.26</u> |
| Cash dividend | <u>\$.165</u> | <u>\$.15</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, 2002 and 2001
(dollars in thousands, except per share data)

| | <u>2002</u> | <u>2001</u> |
|--|------------------|------------------|
| Revenues: | | |
| Premiums earned | \$566,737 | \$541,450 |
| Investment income, net of investment expenses | 64,747 | 63,856 |
| Realized investment losses | (20,448) | (7,532) |
| Other income | <u>11,610</u> | <u>11,809</u> |
| Total revenues | <u>622,646</u> | <u>609,583</u> |
| Losses and expenses: | | |
| Losses and loss settlement expenses | 389,789 | 387,936 |
| Amortization of deferred policy acquisition costs | 137,570 | 134,496 |
| Other underwriting expenses | 54,295 | 45,913 |
| Interest expense | 4,278 | 4,701 |
| Other expenses | <u>3,270</u> | <u>4,182</u> |
| Total expenses | <u>589,202</u> | <u>577,228</u> |
| Income before income taxes | 33,444 | 32,355 |
| Income taxes | <u>4,592</u> | <u>3,804</u> |
| Net income | <u>\$ 28,852</u> | <u>\$ 28,551</u> |
| Per common share: | | |
| Basic earnings | <u>\$.97</u> | <u>\$.98</u> |
| Diluted earnings | <u>\$.95</u> | <u>\$.96</u> |
| Cash dividend | <u>\$.465</u> | <u>\$.43</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, 2002
(dollars in thousands)

| | <u>Common Stock</u> | | <u>Additional Paid-in Capital</u> | <u>Accumulated Other Comprehensive Income</u> | <u>Retained Earnings</u> | <u>Treasury Stock</u> | <u>Total</u> |
|--|---------------------|-----------------|---|---|------------------------------|---------------------------|------------------|
| | <u>Shares</u> | <u>Amount</u> | | | | | |
| Balance, December 31, 2001 | 30,444,678 | \$30,445 | \$140,065 | \$44,265 | \$391,088 | \$(15,565) | <u>\$590,298</u> |
| Net income | | | | | 28,852 | | 28,852 |
| Other compre- hensive income, net of tax: Unrealized investment gains, net of reclassification adjustment | | | | 8,428 | | | <u>8,428</u> |
| Comprehensive income | | | | | | | <u>37,280</u> |
| Issuance of common stock | 437,322 | 437 | 7,023 | | | | 7,460 |
| Tax benefit from stock options exercised | | | 1,335 | | | | 1,335 |
| Cash dividend paid | | | | | (13,825) | | <u>(13,825)</u> |
| Balance, September 30, 2002 | <u>30,882,000</u> | <u>\$30,882</u> | <u>\$148,423</u> | <u>\$52,693</u> | <u>\$406,115</u> | <u>\$(15,565)</u> | <u>\$622,548</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, 2002 and 2001
(in thousands)

| | <u>2002</u> | <u>2001</u> |
|--|-----------------|-----------------|
| Cash flows from operating activities: | | |
| Net income | \$ 28,852 | \$ 28,551 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Change in receivables, unearned premiums, prepaid reinsurance and due to affiliate | 2,160 | (14,907) |
| Increase in unpaid losses and loss settlement expenses | 37,114 | 2,904 |
| Deferred income taxes | (1,656) | (5,590) |
| Increase in deferred policy acquisition costs | (8,671) | (4,302) |
| Amortization and depreciation | 2,238 | 2,121 |
| Loss on sale of investments | 20,448 | 7,532 |
| Other, net | (6,148) | 1,475 |
| Net cash provided by operating activities | <u>74,337</u> | <u>17,784</u> |
| Cash flows from investing activities: | | |
| Fixed maturity investments: | | |
| Purchases | (143,125) | (198,924) |
| Sales or maturities | 113,945 | 210,260 |
| Equity securities: | | |
| Purchases | (28,470) | (7,477) |
| Sales | 28,074 | 6,970 |
| Net purchases of short-term investments | (35,357) | (20,393) |
| Purchase of property and equipment | (1,778) | (2,474) |
| Net cash used by investing activities | <u>(66,711)</u> | <u>(12,038)</u> |
| Cash flows from financing activities: | | |
| Issuance of common stock | 7,460 | 7,083 |
| Repayment of debt obligations | (435) | (395) |
| Dividend paid | (13,825) | (12,587) |
| Net cash used by financing activities | <u>(6,800)</u> | <u>(5,899)</u> |
| Increase (decrease) in cash | 826 | (153) |
| Cash at beginning of period | <u>1,839</u> | <u>2,002</u> |
| Cash at end of period | <u>\$ 2,665</u> | <u>\$ 1,849</u> |

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements

1 - Basis of Presentation

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

These financial statements should be read in conjunction with the financial statements and notes for the year ended December 31, 2001 included in the Company's 2001 Annual Report filed with the Securities and Exchange Commission on Form 10-K.

2 - Earnings Per Share

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

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|--|---|-----------------|--|-----------------|
| | 2002 | 2001 | 2002 | 2001 |
| | (in thousands, except per share data) | | | |
| Numerator for basic and diluted earnings per share: | | | | |
| Net income | <u>\$15,216</u> | <u>\$ 7,855</u> | <u>\$28,852</u> | <u>\$28,551</u> |
| Denominator for basic earnings per share -- weighted average shares outstanding | 29,790 | 29,359 | 29,647 | 29,235 |
| Effect of stock incentive plans | <u>595</u> | <u>610</u> | <u>611</u> | <u>596</u> |
| Denominator for diluted earnings per share | <u>30,385</u> | <u>29,969</u> | <u>30,258</u> | <u>29,831</u> |
| Basic earnings per share | <u>\$.51</u> | <u>\$.27</u> | <u>\$.97</u> | <u>\$.98</u> |
| Diluted earnings per share | <u>\$.50</u> | <u>\$.26</u> | <u>\$.95</u> | <u>\$.96</u> |

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

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

| | For the three months ended September 30, 2002 | 2001 | For the nine months ended September 30, 2002 | 2001 |
|-------------------|--|-------------|---|-------------|
| | (in thousands) | | | |
| Number of options | <u>898</u> | <u>-</u> | <u>898</u> | <u>444</u> |

3 - Reinsurance

Premiums earned are net of amounts ceded of \$17,139,000 and \$50,601,000 for the three and nine months ended September 30, 2002, respectively, and \$15,095,000 and \$46,098,000 for the three and nine months ended September 30, 2001, respectively. Losses and loss settlement expenses are net of amounts ceded of \$10,008,000 and \$26,054,000 for the three and nine months ended September 30, 2002, respectively, and \$17,070,000 and \$53,034,000 for the three and nine months ended September 30, 2001, respectively. Such amounts do not include the reinsurance transactions with Harleysville Mutual Insurance Company (Mutual) under the pooling arrangement, but do include the reinsurance described in the following paragraph.

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 \$1,996,000 and \$1,898,000 and losses incurred of \$213,000 and \$3,447,000 for the three months ended September 30, 2002 and 2001, respectively. Harleysville Group ceded to Mutual premiums earned of \$5,859,000 and \$5,379,000 and losses incurred of \$279,000 and \$8,439,000 for the nine months ended September 30, 2002 and 2001, respectively.

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

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

reinsurance pooling agreement provides for the right of offset. Mutual has an A. M. Best rating of "A" (Excellent) and, in accordance with certain state regulatory requirements, maintained \$320.8 million (fair value) of investments in a trust account to secure liabilities under the reinsurance pooling agreement at September 30, 2002.

4 - Contingency

GE Reinsurance Corporation (GE Re) has sought recession of a reinsurance agreement between Mutual and GE Re relating to certain automobile insurance policies written in California through a managing general agent beginning in 1999. Harleysville Group's share of underwriting losses, assumed under the pooling agreement, that have been ceded to GE Re was \$34.4 million from inception through September 30, 2002. Harleysville Group's pooling share of the written premium ceded by Mutual under the agreement was \$3.7 million and \$9.8 million for the nine months ended September 30, 2002 and 2001, respectively, and is likely to continue to decline in the remainder of 2002.

Both Mutual and the Company believe GE Re's claims to be wholly without merit and are litigating the matter vigorously. While the Company does not expect this matter to materially affect its financial condition or results of operations, there can be no assurance of any particular outcome.

In July 2002, the U. S. District Court for the Eastern District of Pennsylvania granted the Company's motion for summary judgement for breach of contract and declared that the contract with GE Re is valid and binding. GE Re has appealed this ruling.

5 - Cash Flows

Net cash tax payments of \$8,750,000 and \$7,183,000 were made in the first nine months of 2002 and 2001, respectively. Cash interest payments of \$2,927,000 and \$3,361,000 were made in the first nine months of 2002 and 2001, respectively.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

6 - Restructuring Charges

In 1999 and 2000, Harleysville Group recorded restructuring charges in connection with the consolidation of its claims offices and field operations. The remaining accrual for these restructurings, which relates to occupancy obligations, is \$63,000 at September 30, 2002. The liability declined from \$194,000 at December 31, 2001 primarily due to payments on the occupancy obligations.

7 - 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, | |
|---------------------------------------|---|------------------|--|------------------|
| | 2002 | 2001 | 2002 | 2001 |
| | (in thousands) | | | |
| Revenues: | | | | |
| Premiums earned: | | | | |
| Commercial lines | \$143,725 | \$126,031 | \$406,414 | \$362,412 |
| Personal lines | <u>52,799</u> | <u>58,773</u> | <u>160,323</u> | <u>179,038</u> |
| Total premiums earned | 196,524 | 184,804 | 566,737 | 541,450 |
| Net investment income | 21,739 | 21,388 | 64,747 | 63,856 |
| Realized investment gains (losses) | 57 | (4,154) | (20,448) | (7,532) |
| Other | <u>3,967</u> | <u>3,783</u> | <u>11,610</u> | <u>11,809</u> |
| Total revenues | <u>\$222,287</u> | <u>\$205,821</u> | <u>\$622,646</u> | <u>\$609,583</u> |
| Income before income taxes: | | | | |
| Underwriting loss: | | | | |
| Commercial lines | \$ (2,459) | \$ (4,984) | \$ (15,612) | \$ (7,462) |
| Personal lines | <u>(3,628)</u> | <u>(5,925)</u> | <u>(8,001)</u> | <u>(24,278)</u> |
| SAP underwriting loss | (6,087) | (10,909) | (23,613) | (31,740) |
| GAAP adjustments | <u>2,650</u> | <u>1,038</u> | <u>8,696</u> | <u>4,845</u> |
| GAAP underwriting loss | (3,437) | (9,871) | (14,917) | (26,895) |
| Net investment income | 21,739 | 21,388 | 64,747 | 63,856 |
| Realized investment gains (losses) | 57 | (4,154) | (20,448) | (7,532) |
| Other | <u>1,366</u> | <u>1,062</u> | <u>4,062</u> | <u>2,926</u> |
| Income before income taxes | <u>\$ 19,725</u> | <u>\$ 8,425</u> | <u>\$ 33,444</u> | <u>\$ 32,355</u> |

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES
(Unaudited)

Notes to Consolidated Financial Statements
(Continued)

8 - Comprehensive Income

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

| | For the three months ended September 30, 2002 | 2001 | For the nine months ended September 30, 2002 | 2001 |
|---|--|-----------------|---|-----------------|
| | (in thousands) | | | |
| Net income | \$15,216 | \$ 7,855 | \$28,852 | \$28,551 |
| Other comprehensive income: | | | | |
| Unrealized investment holding gains (losses) arising during period | 7,298 | (3,169) | (5,038) | (9,581) |
| Less: | | | | |
| Reclassification adjustment for (gains) losses included in net income | <u>(28)</u> | <u>2,769</u> | <u>13,466</u> | <u>4,985</u> |
| Net unrealized investment gains (losses) | <u>7,270</u> | <u>(400)</u> | <u>8,428</u> | <u>(4,596)</u> |
| Comprehensive income | <u>\$22,486</u> | <u>\$ 7,455</u> | <u>\$37,280</u> | <u>\$23,955</u> |

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

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, 2001 included in the Company's 2001 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 judgement 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 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. 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. A decline in fair value of an investment below its cost that is deemed other than temporary 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 involve judgement and consider 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 INC. AND SUBSIDIARIES**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(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. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, 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.

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.

Results of Operations

Premiums earned increased \$11.7 million and \$25.3 million during the three and nine months ended September 30, 2002, respectively. The increases are primarily due to increases in premiums earned for commercial lines of \$17.7 million and \$44.0 million partially offset by decreases of \$6.0 million and \$18.7 million in personal lines premiums earned for the three and nine months ended September 30, 2002, respectively. The increases in premiums earned for commercial lines primarily is due to higher rates partially offset by fewer policy counts. The decreases in premiums earned for personal lines primarily is due to fewer policy counts partially offset by higher rates.

Investment income increased \$0.4 million and \$0.9 million for the three and nine months ended September 30, 2002, respectively, resulting from an increase in invested assets, partially offset by a lower yield on the fixed maturity investment portfolio.

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

Realized investment gains (losses) improved \$4.2 million for the three months ended September 30, 2002 primarily due to lesser losses from equity securities. During the three months ended September 30, 2002, \$4.5 million of losses were recognized on investments that were trading below cost on an other-than-temporary basis. Such losses were offset by sales of equity securities, including securities written down earlier in 2002 that were sold for tax planning purposes. Realized investment losses increased \$12.9 million for the nine months ended September 30, 2002 primarily due to lesser gains on the sale of fixed maturity securities and greater losses from equity securities.

Income before income taxes increased \$11.3 million and \$1.1 million for the three and nine months ended September 30, 2002, respectively. The increase for the three months ended September 30, 2002 was primarily due to the greater investment income, improved realized investment gains and lower underwriting loss. The increase for the nine months ended September 30, 2002 was primarily due to the greater investment income and lower underwriting loss, partially offset by the greater realized losses. Harleysville Group's statutory combined ratio decreased to 101.7% and 101.9% for the three and nine months ended September 30, 2002, respectively, from 104.6% and 104.1% for the three and nine months ended September 30, 2001, respectively. The improved combined ratio is primarily due to better results in personal lines, particularly homeowners. The commercial lines statutory combined ratio decreased to 100.0% for the three months ended September 30, 2002 from 103.0% during the same prior year period and increased to 99.9% for the nine months ended September 30, 2002 from 99.5% during the same prior year period. The three and nine months ended September 30, 2001 include \$3.6 million of commercial lines net losses incurred from the September 11 terrorist acts. Such losses added 2.9 points and 1.0 point to the commercial lines combined ratio for the three and nine months ended September 30, 2001, respectively. Excluding these losses, commercial lines profitability did not change significantly as better results in the commercial multi-peril and automobile lines were partially offset by worse results in workers compensation insurance where losses have been trending higher in recent quarters. Losses ceded under the aggregate catastrophe reinsurance agreement with Mutual decreased \$3.2 million and \$8.2 million for the three and nine months ended September 30, 2002, respectively, due to fewer losses and less severe catastrophes in the 2002 periods.

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

(Continued)

The income tax provision for the three and nine months ended September 30, 2002 includes the tax benefit of \$2.4 million and \$7.1 million associated with tax-exempt investment income, compared to \$2.4 million and \$7.6 million in the same prior year periods.

New Accounting Standard

In June 2001, the Financial Accounting Standards Board issued Statement No. 142, Goodwill and Other Intangible Assets. Statement No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually in accordance with the provisions of Statement No. 142. Harleysville Group adopted the provisions of Statement No. 142 effective January 1, 2002, at which time Harleysville Group ceased to record amortization expense related to its goodwill. The adoption of Statement No. 142 resulted in a \$0.6 million reduction in amortization expense in the nine months ended September 30, 2002 as compared to the nine months ended September 30, 2001. Harleysville Group's goodwill balance was \$23.4 million at September 30, 2002. Harleysville Group completed its analysis of any potential impairment of the goodwill during the second quarter of 2002 and no adjustment was necessary.

Liquidity and Capital Resources

Net cash provided by operating activities increased \$56.6 million for the nine months ended September 30, 2002. The increase primarily is from improved underwriting cash flow.

Net cash used by investing activities increased \$54.7 million for the nine months ended September 30, 2002. The change primarily is from the investment of cash provided by operating activities into short-term investments and fixed maturity securities.

Net cash used by financing activities increased \$0.9 million for the nine months ended September 30, 2002 primarily due to an increase in dividends paid, partially offset by 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

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

(Continued)

period of time in return for a fee. At September 30, 2002, Harleysville Group held cash collateral of \$147.9 million related to securities on loan with a market value of \$144.8 million. Harleysville Group's policy is to require collateral of 102% of the then-current market value of loaned securities as of the close of trading on the preceding business day. Acceptable collateral includes government securities, letters of credit or cash. 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. Other assets includes \$7.9 million of loaned securities in transit which have been sold but not yet delivered and for which collateral is maintained.

Harleysville Group Inc. maintained \$12.1 million of cash and short-term investments at September 30, 2002 which is available for general corporate business purposes including dividends, debt service, capital contributions to subsidiaries, acquisitions and the repurchase of stock. The Company had no material commitments for capital expenditures as of September 30, 2002.

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

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**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, 2001 to September 30, 2002. In addition, the Company has not significantly changed its investment mix or market risk during this period.

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

- (a) Evaluation of disclosure controls and procedures. Our chief executive officer and our co-chief executive officers, after evaluating the effectiveness of our "disclosure of controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules 13a-14(c) and 15d-14(c)) as of a date (the "Evaluation Date") within 90 days before the filing date of this quarterly report, have concluded that as of the Evaluation Date, our disclosure controls and procedures were adequate and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within those entities.
- (b) Changes in internal controls. There were no significant changes in our internal controls or to our knowledge, in other factors that could significantly affect our internal controls and procedures subsequent to the Evaluation Date.

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

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

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HARLEYSVILLE GROUP INC.Date: November 13, 2002

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

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, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Bruce J. Magee, 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:

- (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 13, 2002

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

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, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Walter R. Bateman, Chairman of the Board, President and 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:

- (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 13, 2002

/s/WALTER R. BATEMAN
Walter R. Bateman
Chairman of the Board, and
Chief Executive Officer

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

I, Bruce J. Magee certify that:

1. I have reviewed this quarterly report on Form 10Q of Harleysville Group Inc.;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures 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 quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 13, 2002

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

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

I, Walter R. Bateman certify that:

1. I have reviewed this quarterly report on Form 10Q of Harleysville Group Inc.;
2. Based on my knowledge, this quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures 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 quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 13, 2002

/s/WALTER R. BATEMAN
Walter R. Bateman
Chairman of the Board and
Chief Executive Officer

