

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 [FEE REQUIRED]

For the fiscal year ended December 31, 2002.

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

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
(Address of principal executive offices)

19438-2297
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$1 par value
(Title of class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K .

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

On June 28, 2002, the last business day of the Registrant's most recently completed second fiscal quarter, the aggregate market value (based on the closing sales price on that date) of the voting stock held by non-affiliates of the Registrant was \$378,044,925.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 30,064,517 shares of Common Stock outstanding on March 5, 2003.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the Registrant's annual report to stockholders for the fiscal year ended December 31, 2002 are incorporated by reference in Parts I, II and IV of this report.
2. Portions of the Registrant's proxy statement relating to the annual meeting of stockholders to be held April 23, 2003 are incorporated by reference in Parts I and III of this report.

HARLEYSVILLE GROUP INC.
ANNUAL REPORT ON FORM 10-K

DECEMBER 31, 2002

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PART I

Item 1. Business.

General

Harleysville Group Inc. (the "Company") is an insurance holding company headquartered in Pennsylvania which engages, through its subsidiaries, in the property and casualty insurance business on a regional basis. As used herein, "Harleysville Group" refers to Harleysville Group Inc. and its subsidiaries.

The Company is a Delaware corporation formed by Harleysville Mutual Insurance Company (the "Mutual Company") in 1979 as a wholly-owned subsidiary. In May 1986, the Company completed an initial public offering of its common stock, reducing the percentage of outstanding shares owned by the Mutual Company to approximately 70%. In April 1992, the Mutual Company completed a secondary public offering of a portion of the Company's common stock then owned by it, further reducing the percentage of outstanding shares owned by the Mutual Company. At December 31, 2002, the Mutual Company owned approximately 56% of the Company's outstanding shares.

Harleysville Group and the Mutual Company operate together as a network of regional insurance companies that underwrite a broad line of personal and commercial coverages. These insurance coverages are marketed primarily in the eastern and midwestern United States through approximately 1,700 insurance agencies. Regional offices are maintained in Georgia, Indiana, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, North Carolina, Pennsylvania, Tennessee, and Virginia. The Company's property and casualty insurance subsidiaries are: Harleysville-Atlantic Insurance Company ("Atlantic"), Harleysville Insurance Company ("HIC"), Harleysville Insurance Company of New Jersey ("HNJ"), Harleysville Insurance Company of New York ("HIC New York"), Harleysville Insurance Company of Ohio ("HIC Ohio"), Harleysville Lake States Insurance Company ("Lake States"), Harleysville Preferred Insurance Company ("Preferred"), Harleysville Worcester Insurance Company ("Worcester"), and Mid-America Insurance Company.

The Company has followed a regional strategy. Management believes that the Company's regional organization permits each regional operation to benefit from economies of scale provided by centralized support while encouraging local marketing autonomy and managerial entrepreneurship. Services which directly involve the insured or the agent (i.e., underwriting, claims and marketing)

generally are performed regionally in accordance with Company-wide standards to promote high quality service, while actuarial, investment, legal, data processing and similar services are performed centrally. The Company's network of regional insurance companies has expanded significantly in the last eighteen years. In 1983, the Company acquired Worcester, a property and casualty insurer which has conducted business in New England since 1823. In 1984, HNJ was formed by the Company and began underwriting property and casualty insurance in New Jersey. In 1987, the Company acquired Atlantic, a property and casualty insurer which has conducted business in the southeastern United States since 1905. In 1991, the Company acquired Mid-America (formerly named Connecticut Union Insurance Company), which conducted business in Connecticut, and HIC New York, which conducts business in upstate New York. In 1993, the Company acquired Lake States, which primarily conducts business in Michigan. In 1994, the Company formed HIC Ohio which began underwriting property and casualty insurance in Ohio. In 1997, the Company acquired HIC, which primarily conducts business in Minnesota and neighboring states.

The Company's property and casualty subsidiaries participate in an intercompany pooling arrangement whereby these subsidiaries cede to the Mutual Company all of their net premiums written and assume from the Mutual Company a portion of the pooled business, which includes substantially all of the Mutual Company's property and casualty insurance business. See "Business - Pooling Arrangement."

Business Segments.

Harleysville Group has three segments which consist of the personal lines of insurance, the commercial lines of insurance and the investment function. Financial information about these segments is set forth in Note 14 of the Notes to Consolidated Financial Statements.

Narrative Description of Business.

Property and Casualty Underwriting

Harleysville Group and the Mutual Company together underwrite a broad line of personal and commercial property and casualty coverages, including automobile, homeowners, commercial multi-peril and workers compensation. The Mutual Company and the Company's insurance subsidiaries participate in an intercompany pooling arrangement under which such subsidiaries and the Mutual Company combine their property and casualty business.

Harleysville Group and the Mutual Company have a pooled rating of "A" (excellent) by A.M. Best Company, Inc. ("Best's") based upon 2001 statutory results and operating performance. Best's ratings are based upon factors relevant to policyholders and are not directed toward the protection of investors. Management believes that the Best's rating is an important factor in marketing Harleysville Group's products to its agents and customers.

The following table sets forth ratios for the Company's property and casualty subsidiaries, prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and with statutory accounting practices ("SAP") prescribed or permitted by state insurance authorities. The statutory combined ratio is a standard measure of underwriting profitability. This ratio is the sum of (i) the ratio of incurred losses and loss settlement expenses to net earned premium ("loss ratio"); (ii) the ratio of expenses incurred for commissions, premium taxes, administrative and other underwriting expenses to net written premium ("expense ratio"); and (iii) the ratio of dividends to policyholders to net earned premium ("dividend ratio"). The GAAP combined ratio is calculated in the same manner except that it is based on GAAP amounts and the denominator for each component is net earned premium. When the combined ratio is under 100%, underwriting results are generally considered profitable. Conversely, when the combined ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. Harleysville Group's operating income is a function of both underwriting results and investment income.

HARLEYSVILLE GROUP BUSINESS ONLY

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
GAAP combined ratio	102.2%	104.7%	106.2%
Statutory operating ratios:			
Loss ratio	68.2%	71.2%	71.7%
Expense and dividend ratios	33.7%	33.0%	34.4%
Statutory combined ratio	101.9%	104.2%	106.1%

The following table sets forth the net written premiums and combined ratios by line of insurance, prepared in accordance with statutory accounting practices prescribed or permitted by state insurance authorities, for Harleysville Group for the periods indicated:

HARLEYSVILLE GROUP BUSINESS ONLY

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(dollars in thousands)		
<u>Net Premiums Written</u>			
Commercial:			
Automobile	\$199,511	\$171,106	\$142,589
Workers compensation	114,565	117,583	108,473
Commercial multi-peril	224,709	183,216	159,679
Other commercial	57,272	43,955	35,978
Total commercial	<u>596,057</u>	<u>515,860</u>	<u>446,719</u>
Personal:			
Automobile	125,593	151,270	168,116
Homeowners	67,831	70,679	75,551
Other personal	8,369	9,778	11,086
Total personal	<u>201,793</u>	<u>231,727</u>	<u>254,753</u>
Total Harleysville Group Business	<u>\$797,850</u>	<u>\$747,587</u>	<u>\$701,472</u>

Combined Ratios

Commercial:			
Automobile	91.6%	96.6%	106.9%
Workers compensation	127.4%	105.7%	102.2%
Commercial multi-peril	93.7%	100.2%	105.8%
Other commercial	86.3%	95.5%	95.2%
Total commercial	99.5%	100.0%	104.5%
Personal:			
Automobile	115.8%	112.8%	106.0%
Homeowners	97.6%	117.8%	117.4%
Other personal	74.1%	85.2%	91.2%
Total personal	108.1%	113.1%	108.7%
Total Harleysville Group Business	101.9%	104.2%	106.1%

Pooling Arrangement

The Company's property and casualty subsidiaries participate in an intercompany pooling arrangement with the Mutual Company. The underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for all companies in the pool than they would experience individually and to reduce the risk of loss of any of the pool participants by spreading the risk among all the participants. Each company participating in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposures of a size commensurate with its own capital and surplus. The additional capacity exists because such policy exposures are spread among all the pool participants which each have their own capital and surplus. Regulation is applied to the individual companies rather than to the pool.

Pursuant to the terms of the pooling agreement with the Mutual Company, each of the Company's subsidiary participants cedes premiums, losses and expenses on all of its business to the Mutual Company which, in turn, retrocedes to such subsidiaries a specified portion of premiums, losses and expenses of the Mutual Company and such subsidiaries. Under the terms of the intercompany pooling agreement which became effective January 1, 1986, Preferred and HNJ ceded to the Mutual Company all of their insurance business written on or after January 1, 1986. All of the Mutual Company's property and casualty insurance business written or in force on or after January 1, 1986, was also included in the pooled business. The pooling agreement provides, however, that Harleysville Group is not liable for any losses occurring prior to January 1, 1986. The pooling agreement does not legally discharge Harleysville Group from its primary liability for the full amount of the policies ceded. However, it makes the Mutual Company liable to Harleysville Group to the extent of the business ceded.

The following table sets forth a chronology of the changes that have occurred in the pooling agreement since it became effective on January 1, 1986.

Chronology of Changes in Pooling Agreement

<u>Date</u>	<u>Harleysville Group Percentage</u>	<u>Mutual Company Percentage</u>	<u>Event</u>
January 1, 1986	30%	70%	Current pooling agreement began with Preferred and HNJ as participants with the Mutual Company.
July 1, 1987	35%	65%	Atlantic acquired and included in the pool.
January 1, 1989	50%	50%	Worcester included in the pool.
January 1, 1991	60%	40%	HIC New York and Mid-America acquired and included in the pool and the Mutual Company formed Pennland (not a pool participant) to write Pennsylvania personal automobile business.
January 1, 1996	65%	35%	Pennland included in the pool.
January 1, 1997	70%	30%	Lake States included in the pool.
January 1, 1998	72%	28%	HIC included in the pool.

Effective as of January 1, 1992, Harleysville-Garden State Insurance Company (Garden State), a subsidiary of the Mutual Company, began insuring new and renewal New Jersey personal automobile insurance policies that had been included in the pooling arrangement. Garden State is not a participant in the pooling arrangement.

When pool participation percentages increased as described above, cash and investments equal to the net increase in liabilities assumed less a ceding commission related to the net increase in the liability for unearned premiums, was transferred from the Mutual Company to Harleysville Group. See Management's Discussion and Analysis of Financial Condition and Results of Operations.

All premiums, losses, loss settlement expenses and other underwriting expenses are prorated among the parties to the pooling arrangement on the basis of their participation in the pool. The method of establishing reserves is set forth under "Business - Reserves." The pooling agreement may be amended or terminated by agreement of the parties. Termination may occur only at the end of a calendar year. The Boards of Directors of the Company and the Mutual Company maintain a coordinating committee which reviews and evaluates, and when changes are warranted, approve the pooling arrangements between the Company and the Mutual Company. See "Business-Relationship with the Mutual Company." In evaluating pool participation changes, the

coordinating committee considers current and proposed acquisitions, the relative capital positions and revenue contributions of the pool participants, and growth prospects and ability to access capital markets to support that growth. Harleysville Group does not intend to terminate its participation in the pooling agreement.

The following table sets forth the net premiums written and combined ratios by line of insurance for the total pooled business after elimination of management fees, prepared in accordance with statutory accounting practices prescribed or permitted by state insurance authorities, for the periods indicated.

	TOTAL POOLED BUSINESS		
	Year Ended December 31,		
	2002	2001	2000
	(dollars in thousands)		
<u>Net Premiums Written</u>			
Commercial:			
Automobile	\$ 277,807	\$ 238,262	\$198,579
Workers compensation	159,118	163,310	150,657
Commercial multi-peril	317,657	259,082	225,960
Other	<u>81,152</u>	<u>62,324</u>	<u>51,154</u>
Total commercial	<u>835,734</u>	<u>722,978</u>	<u>626,350</u>
Personal:			
Automobile	175,076	210,834	234,347
Homeowners	96,504	100,685	107,632
Other	<u>11,631</u>	<u>13,588</u>	<u>15,406</u>
Total personal	<u>283,211</u>	<u>325,107</u>	<u>357,385</u>
Total pooled business	<u>\$1,118,945</u>	<u>\$1,048,085</u>	<u>\$983,735</u>
<u>Combined Ratios</u>⁽¹⁾			
Commercial:			
Automobile	91.4%	96.7%	107.3%
Workers compensation	127.9%	105.5%	102.8%
Commercial multi-peril	91.9%	99.1%	104.6%
Other	84.5%	94.4%	93.3%
Total commercial	98.6%	99.5%	104.2%
Personal:			
Automobile	115.8%	113.2%	106.2%
Homeowners	95.6%	121.9%	117.4%
Other	73.9%	85.3%	91.2%
Total personal	107.3%	114.7%	108.9%
Total pooled business	101.0%	104.4%	105.9%

⁽¹⁾ See the definition of combined ratio in "Business-Property and Casualty Underwriting".

The combined ratio for the total pooled business differs from Harleysville Group's combined ratio primarily because of the effect of the aggregate catastrophe reinsurance agreement with the Mutual Company. See Note 2(a) of the Notes to Consolidated Financial Statements and Business-Reinsurance.

Reserves. Loss reserves are estimates at a given point in time of what the insurer expects to pay to claimants for claims occurring on or before such point in time, including claims which have been incurred but not yet been reported to the insurer. These are estimates, and it can be expected that the ultimate liability will exceed or be less than such estimates. During the loss settlement period, additional facts regarding individual claims may become known, and consequently it often becomes necessary to refine and adjust the estimates of liability.

Harleysville Group maintains reserves for estimates of the ultimate unpaid cost of all losses incurred, including losses for claims which have been incurred but have not yet been reported to Harleysville Group. Loss settlement expense reserves are intended to cover the ultimate costs of settling all claims, including investigation and litigation costs relating to such claims. The amount of loss reserves for reported claims is based primarily upon a case-by-case evaluation of the type of risk involved and knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amounts of loss reserves for incurred but 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 actuarial techniques. With the exception of reserves relating to some workers compensation long-term disability cases, loss reserves are not discounted.

The following table sets forth a reconciliation of beginning and ending net reserves for unpaid losses and loss settlement expenses for the years indicated for the total pooled business on a statutory basis.

TOTAL POOLED BUSINESS			
Year Ended December 31,			
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Reserves for losses and loss settlement expenses, beginning of the year	<u>\$1,147,517</u>	<u>\$1,136,848</u>	<u>\$1,181,066</u>
Incurring losses and loss settlement expenses:			
Provision for insured events of the current year	730,924	756,289	759,471
Decrease in provision for insured events of prior years	<u>(3,816)</u>	<u>(22,444)</u>	<u>(65,319)</u>
Total incurred losses and loss settlement expenses	<u>727,108</u>	<u>733,845</u>	<u>694,152</u>
Payments:			
Losses and loss settlement expenses attributable to insured events of the current year	277,603	327,615	346,846
Losses and loss settlement expenses attributable to insured events of prior years	<u>372,642</u>	<u>395,561</u>	<u>391,524</u>
Total payments	<u>650,245</u>	<u>723,176</u>	<u>738,370</u>
Reserves for losses and loss settlement expenses, end of the year	<u>\$1,224,380</u>	<u>\$1,147,517</u>	<u>\$1,136,848</u>

The following table sets forth the development of net reserves for unpaid losses and loss settlement expenses from 1992 through 2002 for the pooled business of the Mutual Company and Harleysville Group on a statutory basis. "Reserve for losses and loss settlement expenses" sets forth the estimated liability for unpaid losses and loss settlement expenses recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of losses and loss settlement expenses for claims arising in the current and all prior years that are unpaid at the balance sheet date, including losses incurred but not reported.

The "Reserves reestimated" portion of the table shows the reestimated amount of the previously recorded liability based on experience of each succeeding year. The estimate is increased or decreased as payments are made and more information becomes known about the severity of remaining unpaid claims. For example, the 1992 liability has developed a redundancy after ten years, in that reestimated losses and loss settlement expenses are expected to be lower than the initial estimated liability established in 1992 of \$784.5 million by \$33.5 million, or 4.3%.

The "Cumulative amount of reserves paid" portion of the table shows the cumulative losses and loss settlement expense payments made in succeeding years for losses incurred prior to the balance sheet date. For example, the 1992 column indicates that as of December 31, 2002, payments of \$691.1 million of the currently reestimated ultimate liability for losses and loss settlement expenses had been made.

The "Redundancy" portion of the table shows the cumulative redundancy at December 31, 2002 of the reserve estimate shown on the top line of the corresponding column. A redundancy in reserves means that reserves established in prior years exceeded actual losses and loss settlement expenses or were reevaluated at less than the original reserved amount.

The following table includes all 2002 pool participants as if they had participated in the pooling arrangement in all years indicated except for acquired pool participant companies, which are included from their date of acquisition. Under the terms of the pooling arrangement, Harleysville Group is not responsible for losses on the pooled business occurring prior to January 1, 1986.

TOTAL POOLED BUSINESS

Year Ended December 31,

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	(dollars in thousands)										
Reserve for losses and loss settlement expenses	\$784,514	\$825,028	\$855,305	\$900,336	\$1,033,376	\$1,124,910	\$1,172,664	\$1,181,066	\$1,136,848	\$1,147,517	\$1,224,380
Reserves reestimated:											
One year later	781,746	819,494	837,255	856,493	995,656	1,068,687	1,090,640	1,115,747	1,114,404	1,143,701	
Two years later	778,064	802,213	817,330	820,894	961,228	1,005,208	1,042,183	1,097,544	1,124,881		
Three years later	774,420	800,129	800,365	799,191	918,006	972,318	1,027,968	1,106,107			
Four years later	776,687	792,901	790,234	768,704	894,015	961,721	1,028,927				
Five years later	770,420	786,731	768,815	748,667	887,697	962,861					
Six years later	767,777	771,015	753,928	743,859	890,713						
Seven years later	756,912	759,080	750,226	747,954							
Eight years later	749,287	755,744	753,753								
Nine years later	746,889	760,274									
Ten years later	750,994										
Cumulative amount of reserves paid:											
One year later	244,210	255,078	246,935	273,744	328,691	338,377	358,526	391,524	395,561	372,642	
Two years later	402,394	403,601	406,944	448,497	523,307	540,522	562,908	609,016	609,777		
Three years later	503,309	511,281	525,840	566,804	656,234	674,740	695,315	753,893			
Four years later	572,656	587,900	599,336	643,451	741,013	756,502	777,204				
Five years later	616,940	629,908	645,271	690,301	790,902	801,602					
Six years later	639,186	657,570	677,668	720,664	821,164						
Seven years later	656,913	677,123	698,652	740,151							
Eight years later	671,091	691,518	712,800								
Nine years later	682,514	702,435									
Ten years later	691,098										
Redundancy	33,520	64,754	101,552	152,382	142,663	162,049	143,737	74,959	11,967	3,816	
Redundancy expressed as a percent of year end reserves	4.3%	7.8%	11.9%	16.9%	13.8%	14.4%	12.3%	6.3%	1.1%	0.3%	
Cumulative redundancy excluding pre-1986 reserve development ⁽¹⁾	58,819	89,026	124,163	171,452	156,988	171,463	150,664	80,354	14,975	5,997	

⁽¹⁾ Excludes years not included in pooling arrangement with Harleysville Group.

Harleysville Group's reserves primarily are derived from those established for the total pooled business. The terms of the pooling agreement provide that Harleysville Group is responsible only for pooled losses incurred on or after the effective date, January 1, 1986. The GAAP loss reserve experience of Harleysville Group, as reflected in its financial statements, is shown in the following table which sets forth a reconciliation of beginning and ending net reserves for unpaid losses and loss settlement expenses for the years indicated for the business of Harleysville Group only.

HARLEYSVILLE GROUP BUSINESS ONLY

	Year Ended December 31,		
	2002	2001	2000
	(in thousands)		
Reserves for losses and loss settlement expenses, beginning of the year	<u>\$800,861</u>	<u>\$792,584</u>	<u>\$823,914</u>
Incurred losses and loss settlement expenses:			
Provision for insured events of the current year	526,265	537,172	541,738
Decrease in provision for insured events of prior years	<u>(4,648)</u>	<u>(17,350)</u>	<u>(48,937)</u>
Total incurred losses and loss settlement expenses	<u>521,617</u>	<u>519,822</u>	<u>492,801</u>
Payments:			
Losses and loss settlement expenses attributable to insured events of the current year	199,874	229,435	244,978
Losses and loss settlement expenses attributable to insured events of prior years	<u>265,422</u>	<u>282,110</u>	<u>279,153</u>
Total payments	<u>465,296</u>	<u>511,545</u>	<u>524,131</u>
Reserves for losses and loss settlement expenses, end of the year	<u>\$857,182</u>	<u>\$800,861</u>	<u>\$792,584</u>

See page 16 for reconciliation of net reserves to gross reserves.

Harleysville Group recognized a decrease in the provision for insured events of prior years (favorable development) of \$4.6, \$17.4 and \$48.9 million in 2002, 2001, and 2000, respectively. The favorable development for 2002 primarily relates to lower-than-expected claim severity in the commercial and personal lines of business. The favorable development for 2001 primarily relates to lower-than-expected loss adjusting expenses and, for 2000, lower-than-expected claim severity in the commercial and personal lines of business. The 2001 and 2000 favorable development includes \$14.8 million and \$20.2 million of reductions in loss settlement expenses. In both years, such reductions are related to benefits from initiatives to reduce costs of adjusting claims and to the favorable development on losses.

The following table sets forth the development of net reserves for unpaid losses and loss settlement expenses for Harleysville Group. The effect of changes to the pooling agreement participation is reflected in this table. For example, the January 1, 1996 increase in Harleysville Group's pooling participation from 60% to 65% is reflected in the first line of the 1996 column. Amounts of assets equal to increases in net liabilities was transferred to Harleysville Group from the Mutual Company in conjunction with each respective pooling change. The amount of the assets transferred has been netted against and has reduced the cumulative amounts paid for years prior to the pooling changes. For example, the 1995 column of the "Cumulative amount of reserves paid" portion of the table reflects the assets transferred in conjunction with the 1996 increase in the pooling percentage from 60% to 65% as a decrease netted in the "one year later" line. The cumulative amounts paid are reflected in this manner to maintain comparability. This is because when Harleysville Group pays claims subsequent to the date of a pool participation increase, the amounts paid are greater, however, the prior year's reserve amounts are reflective of a lower pool participation percentage. By reflecting pooling participation increases in this manner, loss development is not obscured. Loss development reflects Harleysville Group's share of the total pooled business loss development since January 1, 1986 when Harleysville Group began participation, plus loss development of any subsidiary not participating in the pooling agreement.

Loss development information for the total pooled business is presented on pages 12 to 14 to provide greater analysis of underlying claims development.

HARLEYSVILLE GROUP BUSINESS

Year Ended December 31,

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	(dollars in thousands)										
Reserve for losses and loss settlement expenses	\$437,883	\$499,272	\$535,452	\$576,653	\$718,700	\$793,563	\$813,519	\$823,914	\$792,584	\$800,861	\$857,182
Reserves reestimated:											
One year later	438,135	496,057	524,565	541,654	688,972	750,956	753,987	774,977	775,234	796,213	
Two years later	435,005	483,635	507,090	513,555	662,393	704,157	717,324	761,234	781,117		
Three years later	430,728	477,164	491,919	496,138	630,170	678,757	706,491	765,816			
Four years later	429,125	468,804	482,834	473,084	611,179	670,534	705,615				
Five years later	421,408	462,571	466,309	456,940	606,037	669,789					
Six years later	417,715	450,152	453,934	452,885	606,642						
Seven years later	408,789	439,842	450,675	454,267							
Eight years later	401,582	436,846	451,648								
Nine years later	399,261	438,538									
Ten years later	400,647										
Cumulative amount of reserves paid:											
One year later	144,465	161,557	164,849	105,774	200,907	228,622	252,972	279,153	282,110	265,422	
Two years later	234,991	254,840	219,225	204,030	330,158	371,624	397,685	433,901	434,579		
Three years later	292,381	290,667	283,816	281,546	423,337	465,897	491,274	536,547			
Four years later	314,848	329,830	330,705	334,204	482,016	523,050	548,696				
Five years later	335,411	355,338	361,250	365,574	516,221	553,984					
Six years later	347,731	372,727	382,214	385,720	536,473						
Seven years later	357,966	384,443	395,607	398,214							
Eight years later	365,812	393,092	404,257								
Nine years later	372,321	399,416									
Ten years later	376,965										
Redundancy	37,236	60,734	83,804	122,386	112,058	123,774	107,904	58,098	11,467	4,648	
Redundancy expressed as a percent of year end reserves	8.5%	12.2%	15.7%	21.2%	15.6%	15.6%	13.3%	7.1%	1.4%	0.6%	
Gross reserve	\$486,608	\$560,811	\$603,088	\$645,941	\$796,820	\$868,393	\$893,420	\$901,352	\$864,843	\$879,056	\$928,335
Ceded reserve	48,725	61,539	67,636	69,288	78,120	74,830	79,901	77,438	72,259	78,195	71,153
Net reserve	<u>\$437,883</u>	<u>\$499,272</u>	<u>\$535,452</u>	<u>\$576,653</u>	<u>\$718,700</u>	<u>\$793,563</u>	<u>\$813,519</u>	<u>\$823,914</u>	<u>\$792,584</u>	<u>\$800,861</u>	<u>\$857,182</u>
Gross re-estimated	\$452,444	\$509,519	\$522,302	\$525,397	\$685,556	\$748,266	\$785,044	\$858,086	\$889,122	\$893,981	
Ceded re-estimated	51,797	70,981	70,654	71,130	78,914	78,477	79,429	92,270	108,005	97,768	
Net re-estimated	<u>\$400,647</u>	<u>\$438,538</u>	<u>\$451,648</u>	<u>\$454,267</u>	<u>\$606,642</u>	<u>\$669,789</u>	<u>\$705,615</u>	<u>\$765,816</u>	<u>\$781,117</u>	<u>\$796,213</u>	

Note: The amount of cash and investments received equal to the increase in liabilities for unpaid losses and loss settlement expenses was \$93,966,000, \$28,318,000, and \$12,392,000 for the changes in pool participation in 1996, 1997, and 1998, respectively.

Reinsurance. Harleysville Group follows the customary industry practice of reinsuring a portion of its exposures and paying to the reinsurers a portion of the premiums received. Insurance is ceded principally to reduce the net liability on individual risks and to protect against catastrophic losses. Reinsurance does not legally discharge an insurer from its primary liability for the full amount of the policies, although it does make the assuming reinsurer liable to the insurer to the extent of the reinsurance ceded. Therefore, a ceding company is subject to credit risk with respect to its reinsurers.

The reinsurance described below is maintained for the Company's subsidiaries and the Mutual Company and its wholly-owned subsidiaries. Reinsurance premiums and recoveries are allocated to participants in the pooling agreement according to pooling percentages.

Reinsurance for property and auto physical damage losses is currently maintained under a per risk excess of loss treaty affording recovery to \$8.5 million above a retention of \$1.5 million. Harleysville Group's 2002 pooling share of such recovery would be \$6.1 million above a retention of \$1.1 million. In addition, the Company's subsidiaries and the Mutual Company and its wholly-owned subsidiaries are reinsured under a catastrophe reinsurance treaty effective for one year from July 1, 2002 which provides coverage ranging from 84.8% to 94.3% of up to \$140.0 million in excess of a retention of \$30.0 million for any given catastrophe. Harleysville Group's 2002 pooling share of this coverage would range from 84.8% to 94.3% of up to \$100.8 million in excess of a retention of \$21.6 million for any given catastrophe. Accordingly, pursuant to the terms of the treaty, the maximum recovery would be \$126.5 million for any catastrophe involving an insured loss equal to or greater than \$170.0 million. Harleysville Group's pooling share of this maximum recovery would be \$91.1 million for any catastrophe involving an insured loss of \$122.4 million or greater. The treaty includes reinstatement provisions providing for coverage for a second catastrophe and requiring payment of an additional premium in the event of a first catastrophe occurring. Most terrorism losses would not be covered by the treaty. Harleysville Group has not purchased funded catastrophe covers. Harleysville Group and Mutual have purchased property per risk excess of loss reinsurance which covers certain terrorism losses and provides for recovery of up to \$8.5 million in excess of \$1.5 million of terrorism losses for any one risk under certain circumstances. The maximum recovery by Harleysville Group on a terrorism loss occurrence is \$27.0 million.

Casualty reinsurance (including liability and workers compensation) is currently maintained under an excess of loss treaty affording recovery to \$38.0 million above a retention of \$2.0 million for each loss occurrence. Harleysville Group's 2002

pooling share of a recovery would be up to \$25.9 million above a retention of \$1.4 million. In addition, there is reinsurance to protect Harleysville Group from large workers compensation losses in 2002. For umbrella liability coverages, reinsurance protection up to \$14.0 million is provided over a retention of \$1.0 million. Harleysville Group's 2002 pooling share would provide for recovery of \$10.1 million over a retention of \$0.7 million. The casualty reinsurance programs provide coverage for a terrorist event with no reinstatement provision.

Harleysville Group has a reinsurance agreement with the Mutual Company whereby the Mutual Company reinsures accumulated catastrophe losses in a quarter up to \$14.4 million in excess of \$3.6 million in return for a reinsurance premium. The agreement excludes catastrophe losses resulting from earthquakes or hurricanes. This agreement was amended effective July 1, 2002 to exclude terrorism losses in order to reflect current reinsurance market conditions. The premium rate and other terms were not changed.

The terms and charges for reinsurance coverage are typically negotiated annually. The reinsurance market is subject to conditions which are similar to those in the direct property and casualty insurance market, and there can be no assurance that reinsurance will remain available to Harleysville Group to the same extent and at the same cost currently maintained.

Harleysville Group considers numerous factors in choosing reinsurers, the most important of which are the financial stability and credit worthiness of the reinsurer. Harleysville Group has not experienced any material collectibility problems for its reinsurance recoverables.

Competition. The property and casualty insurance industry is highly competitive on the basis of both price and service. There are numerous companies competing for the categories of business underwritten by Harleysville Group in the geographic areas where Harleysville Group operates, many of which are substantially larger and have considerably greater financial resources than Harleysville Group. In addition, because the insurance products of Harleysville Group and the Mutual Company are marketed exclusively through independent insurance agencies, most of which represent more than one company, Harleysville Group faces competition within each agency.

Marketing. Harleysville Group markets its insurance products through independent agencies and monitors the performance of these agencies relative to many factors including profitability, growth and retention. At December 31, 2002, there were approximately 1,700 agencies.

Investments

An important element of the financial results of Harleysville Group is the return on invested assets. An investment objective of Harleysville Group is to maintain a widely diversified fixed maturities portfolio structured to maximize after-tax investment income while minimizing credit risk through investments in high quality instruments. An objective also is to provide adequate funds to pay claims without forced sales of investments. At December 31, 2002, substantially all of Harleysville Group's fixed maturity investment portfolio was rated at investment grade and the investment portfolio did not contain any real estate or mortgage loans. Harleysville Group also invests in equity securities with the objective of capital appreciation.

Harleysville Group has adopted and follows an investment philosophy which precludes the purchase of non-investment grade fixed income securities. However, due to uncertainties in the economic environment, it is possible that the quality of investments held in Harleysville Group's portfolio may change.

The following table shows the composition of Harleysville Group's fixed maturity investment portfolio at amortized cost, excluding short-term investments, by rating as of December 31, 2002:

<u>Rating</u> ⁽¹⁾	<u>December 31, 2002</u>	
	<u>Amount</u>	<u>Percent</u>
	(dollars in thousands)	
U.S. Treasury and U.S. agency bonds ⁽²⁾	\$ 282,652	19.7%
Aaa	492,091	34.3
Aa	410,895	28.6
A	220,223	15.3
Baa	27,481	1.9
Ba	3,282	0.2
C	<u>418</u>	<u>0.0</u>
Total	<u>\$1,437,042</u>	<u>100.0%</u>

⁽¹⁾ Ratings assigned by Moody's Investors Services, Inc.

⁽²⁾ Includes GNMA pass-through obligations and collateralized mortgage obligations.

Harleysville Group invests in both taxable and tax-exempt fixed income securities as part of its strategy to maximize after-tax income. Such strategy considers, among other factors, the impact of the alternative minimum tax. Tax-exempt bonds made up approximately 44%, 40% and 45% of the total investment portfolio at December 31, 2002, 2001 and 2000, respectively.

The following table shows the composition of Harleysville Group's investment portfolio at carrying value, excluding short-term investments, by type of security as of December 31, 2002:

	<u>December 31, 2002</u>	
	<u>Amount</u>	<u>Percent</u>
	(dollars in thousands)	
Fixed maturities:		
U.S. Treasury obligations	\$ 41,557	2.6%
U.S. agency obligations	33,888	2.1
Mortgage-backed securities	228,367	14.1
Obligations of states and political subdivisions	703,558	43.5
Corporate securities	<u>502,661</u>	<u>31.1</u>
Total fixed maturities	<u>1,510,031</u>	<u>93.4</u>
Equity securities	<u>107,177</u>	<u>6.6</u>
Total	<u>\$1,617,208</u>	<u>100.0%</u>

Investment results of Harleysville Group's fixed maturity investment portfolio are as shown in the following table:

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(dollars in thousands)		
Invested assets ⁽¹⁾	\$1,416,294	\$1,379,551	\$1,361,310
Investment income ⁽²⁾	\$ 84,438	\$ 83,191	\$ 83,958
Average yield	6.0%	6.0%	6.2%

(1) Average of the aggregate invested amounts at amortized cost at the beginning and end of the period.

(2) Investment income does not include investment expenses, realized investment gains or losses or provision for income taxes.

The following table indicates the composition of Harleysville Group's fixed maturity investment portfolio at carrying value, excluding short-term investments, by time to maturity as of December 31, 2002:

	<u>December 31, 2002</u>	
	<u>Amount</u>	<u>Percent</u>
	(dollars in thousands)	
<u>Due in⁽¹⁾</u>		
1 year or less	\$ 124,689	8.3%
Over 1 year through 5 years	435,433	28.8
Over 5 years through 10 years	601,700	39.9
Over 10 years	<u>119,842</u>	<u>7.9</u>
	<u>1,281,664</u>	<u>84.9</u>
Mortgage-backed securities	<u>228,367</u>	<u>15.1</u>
Total	<u>\$1,510,031</u>	<u>100.0%</u>

(1) Based on stated maturity dates with no prepayment assumptions. Actual maturities may differ because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The average expected life of Harleysville Group's investment portfolio as of December 31, 2002 was approximately 4.6 years.

Regulation

Insurance companies are subject to supervision and regulation in the states in which they transact business. Such supervision and regulation relate to numerous aspects of an insurance company's business and financial condition. The primary purpose of such supervision and regulation is the protection of policyholders. The extent of such regulation varies, but generally derives from state statutes which delegate regulatory, supervisory and administrative authority to state insurance departments. Accordingly, the authority of the state insurance departments includes the establishment of standards of solvency which must be met and maintained by insurers, the licensing to do business of insurers and agents, the nature of and limitations on investments, premium rates for property and casualty insurance, the provisions which insurers must make for current losses and future liabilities, the deposit of securities for the benefit of policyholders and the approval of policy forms. Such insurance departments also conduct periodic examinations of the affairs of insurance companies and require the filing of annual and other reports relating to the financial condition of insurance companies.

All of the states in which Harleysville Group and the Mutual Company do business have guaranty fund laws under which insurers doing business in such states can be assessed up to 2% of annual premiums written by the insurer in that state in order to fund policyholder liabilities of insolvent insurance companies. Under these laws in general, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of policyholder and third party claims against insolvent insurers.

State laws also require Harleysville Group to participate in involuntary insurance programs for automobile insurance, as well as other property and casualty lines, in states in which Harleysville Group writes such lines. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements ("FAIR") plans, reinsurance facilities and wind storm plans. These state laws generally require all companies that write lines covered by these programs to provide coverage (either directly or through reinsurance) for insureds who cannot obtain insurance in the voluntary market. The legislation creating these programs usually allocates a pro rata portion of risks attributable to such insureds to each company on the basis of direct written premiums or the number of automobiles insured.

Generally, state law requires participation in such programs as a condition to doing business. The loss ratio on insurance written under involuntary programs generally has been greater than the loss ratio on insurance in the voluntary market.

State insurance holding company acts regulate insurance holding company systems. Each insurance company in the holding company system is required to register with the insurance supervisory agency of its state of domicile and furnish certain information concerning transactions between companies within the holding company system that may materially affect the operations, management or financial condition of the insurer within the system, including the payment of dividends from the insurance subsidiaries to the Company.

Insurance holding company acts require that all transactions involving any insurer within the holding company system, including those involving the Mutual Company and the Company's insurance subsidiaries, must be fair and equitable to that insurer. Further, approval of the applicable insurance commissioner is required prior to the consummation of a transaction affecting the control of an insurer.

The Terrorism Risk Insurance Act of 2002 (TRIA), signed into law on November 26, 2002, provides a federal backstop for losses related to the writing of the terrorism peril in property casualty insurance policies. Under TRIA, the Companies had until February 24, 2003, to notify commercial policyholders about requirements of the law, let them know that the Company was required to offer coverage for acts of terrorism certified under TRIA and let them know how the coverage would be priced.

Harleysville Group distributed the mandated disclosure which explained the Act and notified policyholders of their coverage options. The terrorism rating plan, with rates that vary based on geographical and risk-type factors, will begin to go into effect in 2003. The plan will charge commercial policies a nominal terrorism premium in most territories to encourage coverage acceptance while minimizing the administrative costs.

The property and casualty insurance industry has been subject to significant public scrutiny and comment primarily due to concerns regarding solvency issues, rising insurance costs, and the industry's methods of operations. Accordingly, regulations and legislation may be proposed to bring the insurance industry

under federal control; to strengthen state oversight, particularly in the field of solvency and investments; to further restrict an insurer's flexibility in underwriting and pricing risks; and to impose new taxes and assessments. It is not possible to predict whether, in what form or in what jurisdictions any of these proposals might be adopted or the effect, if any, on Harleysville Group.

The Company's insurance subsidiaries generally are restricted by the insurance laws of their respective states of domicile as to the amount of dividends they may pay to the Company without the prior approval of the respective state regulatory authorities. Generally, the maximum dividend that may be paid by an insurance subsidiary during any year without prior regulatory approval is limited to a stated percentage of that subsidiary's statutory surplus as of a certain date, or adjusted net income of the subsidiary, for the preceding year. Applying the current regulatory restrictions as of December 31, 2002, \$11.0 million would be available for distribution to Harleysville Group Inc. without prior approval until October 1, 2003, after which \$52.9 million would be available for distribution to Harleysville Group Inc. without prior approval. The Company's insurance subsidiaries paid dividends of \$12.0 million in 2002, \$10.0 in 2001 and, \$20.0 million in 2000 to Harleysville Group Inc. An additional \$42.0 million in aggregate dividends were declared by the Company's insurance subsidiaries in 2002 and remain as a receivable on the books of the Company at December 31, 2002.

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

Various states have adopted the NAIC's Codification of Statutory Accounting Principles which were effective January 1, 2001. The codified principles are intended to provide a basis of accounting recognized and adhered to in the absence of, conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the January 1, 2001 statutory capital and surplus of the Company's insurance subsidiaries ranged from a decrease of \$0.4 million to an increase of \$6.4 million and was an increase of \$21.0 million on a consolidated basis.

Harleysville Group is required to file financial statements for its subsidiaries, prepared by using statutory accounting practices, with state regulatory authorities. SAP differs from GAAP primarily in the recognition of revenue and expense. The adjustments necessary to reconcile net income and shareholders' equity determined by using SAP to net income and shareholders' equity determined in accordance with GAAP are as follows:

	<u>Net Income</u>			<u>Shareholders' Equity</u>	
	<u>Year Ended December 31,</u>			<u>December 31,</u>	
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>2002</u>	<u>2001</u>
			(in thousands)		
SAP amounts	\$42,338	\$41,095	\$48,412	\$509,344	\$538,878
Adjustments:					
Deferred policy acquisition costs	8,820	1,317	1,218	94,896	86,076
Deferred income taxes	(708)	3,626	1,608	357	6,093
Unrealized investment gains				72,985	26,857
Other, net	(3,925)	(2,443)	(2,109)	(6,768)	3,526
Holding company ⁽¹⁾	<u>(270)</u>	<u>(102)</u>	<u>(437)</u>	<u>(38,702)</u>	<u>(71,132)</u>
GAAP amounts	<u>\$46,255</u>	<u>\$43,493</u>	<u>\$48,692</u>	<u>\$632,112</u>	<u>\$590,298</u>

⁽¹⁾ Represents the GAAP income and equity amounts for Harleysville Group Inc., excluding the earnings of and investment in subsidiaries.

Relationship with the Mutual Company

Harleysville Group's operations are interrelated with the operations of the Mutual Company due to the pooling arrangement and other factors. The Mutual Company owed approximately 56% of the issued and outstanding common stock of Harleysville Group Inc. at December 31, 2002. Harleysville Group employees provide a variety of services to the Mutual Company and its wholly-owned subsidiaries. The cost of facilities and employees required to conduct the business of both companies is charged on a cost-allocated basis. Harleysville Group also manages the operations of the Mutual Company and its wholly-owned subsidiaries pursuant to a management agreement which commenced January 1, 1993 under

which Harleysville Group received a management fee. Harleysville Group also manages the operations of Berkshire Mutual Insurance Company, a small property and casualty insurance company, pursuant to a management services agreement. Harleysville Group received \$6.8 million, \$7.3 million, and \$7.4 million for the years ended December 31, 2002, 2001 and 2000, respectively, for all such management services.

All of the Company's officers are officers of the Mutual Company, and six of the Company's nine directors are directors of the Mutual Company. A coordinating committee exists to review and evaluate the pooling agreement and other material transactions between Harleysville Group and the Mutual Company and is responsible for matters involving actual or potential conflicts of interest between the two companies. The coordinating committee consists of six non-employee directors, three from Harleysville Group Inc. and three from the Mutual Company all of whom are not members of both Boards and one, a non-voting Chairman, who is a member of both Boards. The decisions of the coordinating committee are binding on the two companies. No intercompany transaction can be authorized by the coordinating committee unless at least two of three of the Company's committee members conclude that such transaction is fair and equitable to Harleysville Group. For information concerning the members of the coordinating committee, see "Board and Committee Meetings" section on pages 8 to 10 of the Company's proxy statement relating to the annual meeting of the shareholders to be held April 23, 2003 which is incorporated by reference in this Form 10-K Report.

The Mutual Company leases the home office from Harleysville Group with which it shares most of the facility. Rental income under the lease was \$3.5 million for 2002 and 2001 and \$3.4 million for 2000. Harleysville Group believes that the lease terms are no less favorable to it than if the property were leased to a non-affiliate.

In connection with the acquisition of Mid-America and HIC New York, the Company borrowed approximately \$18.5 million from the Mutual Company. See Note 8 of the Notes to Consolidated Financial Statements. For additional information with respect to transactions with the Mutual Company, see Note 2 of the Notes to Consolidated Financial Statements.

Employees

All employees are paid by Harleysville Group Inc. and, accordingly, are considered to be employees of Harleysville Group Inc. As of December 31, 2002, there were 2,413 employees. They provide a variety of services to the Mutual Company and its wholly-owned subsidiaries. See "Business-Relationship with the Mutual Company" and Note 2 of the Notes to Consolidated Financial Statements.

Available Information

The Company maintains a website at www.harleysvillegroup.com. Our annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, are available free of charge on our website as soon as practicable after electronic filing of such material with, or furnishing it to, the Securities and Exchange Commission.

Item 2. Properties.

The buildings which house the headquarters of Harleysville Group and the Mutual Company are leased to the Mutual Company by a subsidiary of Harleysville Group. See "Business-Relationship with the Mutual Company." The Mutual Company charges Harleysville Group for an appropriate portion of the rent under an intercompany allocation agreement. The buildings containing the headquarters of Harleysville Group and the Mutual Company have approximately 220,000 square feet of office space. Harleysville Group also rents office facilities in certain of the states in which it does business.

Item 3. Legal Proceedings.

In 2001, GE Reinsurance Corporation (GE Re) sought rescission 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. On December 13, 2002, Mutual and GE Re settled this matter by agreeing to a commutation and termination of the reinsurance agreement effective December 31, 2002. The settlement agreement did not materially impact Harleysville Group's financial statements.

Item 4. Submission of Matters to a Vote of Security Holders.

No matter was submitted to a vote of the security holders during the fourth quarter of 2002.

PART II

Item 5. Market for the Registrant's Common Stock and Related Stockholder Matters.

The "Market for Common Stock and Related Security Holder Matters" section from the Company's annual report to stockholders for the year ended December 31, 2002, which is included as Exhibit (13)(E) to this Form 10-K Report, is incorporated herein by reference.

Item 6. Selected Financial Data.

The "Selected Consolidated Financial Data" section from the Company's annual report to stockholders for the year ended December 31, 2002, which is included as Exhibit (13)(A) to this Form 10-K Report, is incorporated herein by reference.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The "Management's Discussion and Analysis of Results of Operations and Financial Condition" section from the Company's annual report to stockholders for the year ended December 31, 2002, which is included as Exhibit (13)(B) to this Form 10-K Report, is incorporated herein by reference.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The "Quantitative and Qualitative Disclosures About Market Risk" section from the Company's annual report to stockholders for the year ended December 31, 2002, which is included as Exhibit (13)(C) to this Form 10-K Report, is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data.

The consolidated financial statements from the Company's annual report to stockholders for the year ended December 31, 2002, which is included as Exhibit (13)(D) to this Form 10-K Report, are incorporated herein by reference.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

PART III

Item 10. Directors and Executive Officers of the Registrant.

The "Election of Directors" and "Other Executive Officers" sections, which provides information regarding the Company's directors and executive officers, on pages 13 to 16 and the "Section 16 Reporting Compliance" section on page 36 of the Company's proxy statement relating to the annual meeting of stockholders to be held April 23, 2003, are incorporated herein by reference.

Item 11. Executive Compensation.

The information set forth on pages 29 to 34 and the "Compensation of Directors" section on pages 11 and 12 of the Company's proxy statement relating to the annual meeting of stockholders to be held April 23, 2003, are incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

The "Ownership of Common Stock" section on page 21 of the Company's proxy statement relating to the annual meeting of stockholders to be held April 23, 2003, is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions.

The "Transactions with Harleysville Mutual" section on pages 35 and 36 of the Company's proxy statement relating to the annual meeting of stockholders to be held April 23, 2003, is incorporated herein by reference.

Item 14. Controls and Procedures

The Company has procedures in place for accumulating and evaluating information which enable it to prepare and file reports with the Securities and Exchange Commission. As a result of procedures required by the Sarbanes-Oxley Act of 2002, the Company has formed a committee that includes certain members of senior management and key officers to ensure that all information required to be disclosed in the Company's reports is accumulated and communicated to those individuals responsible for the preparation of the reports, and to our principal executive and financial officers, in a manner that will allow timely decisions regarding required disclosures.

Within the 90 days prior to the date of this annual report, the Company carried out an evaluation, under the supervision and with the participation of management, including the chief executive officer and chief financial officer, of the effectiveness of the design and operation of disclosure controls and procedures. Based on that evaluation of these disclosure controls and procedures, the chief executive officer and chief financial officer concluded that Harleysville Group Inc.'s disclosure controls and procedures were effective as of the date of such evaluation.

The chief executive officer and chief financial officer also have concluded that there were no significant changes in the Company's internal controls or in other factors that could significantly affect the internal controls subsequent to the date that the Company completed its evaluation.

PART IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K.

- (a) (1) The following consolidated financial statements are filed as a part of this report:

	<u>Page</u>
Consolidated Financial Statements	
Consolidated Balance Sheets as of December 31, 2002 and 2001	31*
Consolidated Statements of Income for Each of the Years in the Three-year Period Ended December 31, 2002	32*
Consolidated Statements of Shareholders' Equity for Each of the Years in the Three- year Period Ended December 31, 2002	33*
Consolidated Statements of Cash Flows for Each of the Years in the Three-year Period Ended December 31, 2002	34*
Notes to Consolidated Financial Statements	35*
Independent Auditors' Report	45*

- (2) The following consolidated financial statement schedules for the years 2002, 2001 and 2000 are submitted herewith:

Financial Statement Schedules		
Schedule I.	Summary of Investments - Other Than Investments in Related Parties	40
Schedule II.	Condensed Financial Information of Parent Company	41
Schedule III.	Supplementary Insurance Information	44
Schedule IV.	Reinsurance	45
Schedule VI.	Supplemental Insurance Information Concerning Property and Casualty Subsidiaries	46
Independent Auditors' Consent and Report on Schedules (filed as Exhibit 23)		

All other schedules are omitted because they are not applicable or the required information is included in the financial statements or notes thereto.

*Refers to the respective page of Harleysville Group Inc.'s 2002 Annual Report to Stockholders. The Consolidated Financial Statements and Independent Auditors' Report, which are included as Exhibit (13)(D), are incorporated herein by reference. With the exception of the portions of such Annual Report specifically incorporated by reference in this Item and Items 5, 6, 7 and 8, such Annual Report shall not be deemed filed as part of this Form 10-K or otherwise subject to the liabilities of Section 18 of the Securities Exchange Act of 1934.

(3) Exhibits

<u>Exhibit No.</u>	<u>Description of Exhibits</u>
(3)(A)	Amended and restated Certificate of Incorporation of Registrant - incorporated herein by reference to Exhibit (4)(A) to the Registrant's Form S-8 Registration Statement No. 333-03127 filed May 3, 1996.
(3)(B)	Amended and Restated By-laws of Registrant - incorporated herein by reference to Exhibit 4(B) to the Post-Effective Amendment No. 12 of Registrant's Form S-3 Registration Statement No. 33-90810 filed October 10, 1995.
(4)	Indenture between the Registrant and CoreStates Bank, N.A., dated as of November 15, 1993 - incorporated herein by reference to Exhibit (4) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1993.
*(10)(A)	Standard Deferred Compensation Plan for Directors of Harleysville Mutual Insurance Company and Harleysville Group Inc. Amended and Restated November 17, 1999 - incorporated herein by reference to Exhibit 10(A) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1999.
*(10)(B)	Harleysville Insurance Companies Director Deferred Compensation Plan Approved by the Board of Directors November 25, 1987 - incorporated herein by reference to Exhibit 10(B) to the Registrant's Form S-3 Registration Statement No. 33-28948 filed May 25, 1989.
*(10)(C)	Harleysville Group Inc. Non-qualified Deferred Compensation Plan Amended and Restated November 17, 1999 - incorporated herein by reference to Exhibit 10(C) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1999.
*(10)(D)	Pension Plan of Harleysville Group Inc. and Associated Employers dated December 1, 1994 and amendment dated February 6, 1995 - incorporated herein by reference to Exhibit 10(D) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1994.

Exhibit No.	Description of Exhibits
* (10)(E)	Harleysville Mutual Insurance Company/ Harleysville Group Inc. Senior Management Incentive Compensation Plan As Amended and Restated November 17, 1999 - incorporated herein by reference to Exhibit 10(E) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1999.
(10)(F)	Proportional Reinsurance Agreement effective as of January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company and Harleysville Insurance Company of New Jersey - incorporated herein by reference to Exhibit 10(N) to the Registrant's Form S-1 Registration Statement No. 33-4885 declared effective May 23, 1986.
* (10)(G)	Equity Incentive Plan of Registrant, as amended - incorporated herein by reference to Exhibit (4)(C) to the Registrant's Form S-8 Registration Statement No. 333-25817 filed April 25, 1997.
(10)(H)	Tax Allocation Agreement dated December 24, 1986 among Harleysville Insurance Company of New Jersey, Huron Insurance Company, Worcester Insurance Company, McAlear Associates, Inc. and the Registrant - incorporated herein by reference to Exhibit 10(Q) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1986.
(10)(I)	Amended and Restated Financial Tax Sharing Agreement dated March 20, 1995 among Huron Insurance Company, Harleysville Insurance Company of New Jersey, Worcester Insurance Company, Harleysville-Atlantic Insurance Company, New York Casualty Insurance Company, Connecticut Union Insurance Company, Great Oaks Insurance Company, Lakes States Insurance Company and the Registrant - incorporated herein by reference to Exhibit (10)(L) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1994.

<u>Exhibit No.</u>	<u>Description of Exhibits</u>
(10)(J)	Amendment, effective July 1, 1987, to the Proportional Reinsurance Agreement effective January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company, Harleysville Insurance Company of New Jersey and Atlantic Insurance Company of Savannah - incorporated herein by reference to the Registrant's Form 8-K Report dated July 1, 1987.
(10)(K)	Amendment, effective January 1, 1989, to the Proportional Reinsurance Agreement effective January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company, Harleysville Insurance Company of New Jersey, Atlantic Insurance Company of Savannah and Worcester Insurance Company - incorporated herein by reference to Exhibit 10(U) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1988.
(10)(L)	Amendment, effective January 1, 1991, to the Proportional Reinsurance Agreement effective January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company, Harleysville Insurance Company of New Jersey, Atlantic Insurance Company of Savannah, Worcester Insurance Company, Phoenix General Insurance Company and New York Casualty Insurance Company - incorporated herein by reference to Exhibit (10)(O) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1990.
(10)(M)	Amendments, effective January 1, 1995 and 1993, respectively, to the Proportional Reinsurance Agreement effective January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company, Harleysville Insurance Company of New Jersey, Harleysville-Atlantic Insurance Company, Worcester Insurance Company, Connecticut Union Insurance Company, New York Casualty Insurance Company and Great Oaks Insurance Company - incorporated herein by reference to Exhibit (10)(P) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1994.

<u>Exhibit No.</u>	<u>Description of Exhibits</u>
(10)(N)	Amendment, effective January 1, 1996 to the Proportional Reinsurance Agreement effective January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company, Harleysville Insurance Company of New Jersey, Harleysville-Atlantic Insurance Company, Worcester Insurance Company, Connecticut Union Insurance Company, New York Casualty Insurance Company, Great Oaks Insurance Company and Pennland Insurance Company - incorporated herein by reference to Exhibit (10)(O) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1995.
(10)(O)	Amendment, effective January 1, 1997 to the Proportional Reinsurance Agreement effective January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company, Harleysville Insurance Company of New Jersey, Harleysville-Atlantic Insurance Company, Worcester Insurance Company, Mid-America Insurance Company, New York Casualty Insurance Company, Great Oaks Insurance Company, Pennland Insurance Company and Lake States Insurance Company - incorporated herein by reference to Exhibit (10)(P) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1996.
(10)(P)	Amendment, effective January 1, 1998 to the Proportional Reinsurance Agreement effective January 1, 1986 among Harleysville Mutual Insurance Company, Huron Insurance Company, Harleysville Insurance Company of New Jersey, Harleysville-Atlantic Insurance Company, Worcester Insurance Company, Mid-America Insurance Company, New York Casualty Insurance Company, Great Oaks Insurance Company, Pennland Insurance Company, Lake States Insurance Company and Minnesota Fire and Casualty Company - incorporated herein by reference to Exhibit (10)(Q) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1997.

<u>Exhibit No.</u>	<u>Description of Exhibits</u>
(10)(Q)	Lease and amendment effective January 1, 2000 between Harleysville, Ltd. and Harleysville Mutual Insurance Company - incorporated herein by reference to Exhibit 10(R) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1999.
*(10)(R)	1995 Directors' Stock Option Program of Registrant - incorporated herein by reference to Exhibit (10)(S) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1993.
*(10)(S)	Harleysville Group Inc. Year 2000 Directors' Stock Option Program of Registrant - incorporated herein by reference to Exhibit (4)(C) to the Registrant's Form S-8 Registration Statement No. 333-85941, filed August 26, 1999.
(10)(T)	Loan Agreement dated as of March 19, 1998 by and between Harleysville Group Inc. and Harleysville Mutual Insurance Company - incorporated herein by reference to Exhibit (10)(V) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1997.
(10)(U)	Form of Management Agreements dated January 1, 1994 between Harleysville Group Inc. and Harleysville Mutual Insurance Company, Harleysville-Garden State Insurance Company, Mainland Insurance Company, Pennland Insurance Company, Berkshire Mutual Insurance Company and Harleysville Life Insurance Company - incorporated herein by reference to Exhibit (10)(U) to the Registrant's Annual Statement on Form 10-K for the year ended December 31, 1993.

<u>Exhibit No.</u>	<u>Description of Exhibits</u>
(10)(V)	Form of Salary Allocation Agreements dated January 1, 1993 between Harleysville Group Inc. and Harleysville Mutual Insurance Company, Harleysville-Garden State Insurance Company, Mainland Insurance Company, Pennland Insurance Company, Berkshire Mutual Insurance Company and Harleysville Life Insurance Company - incorporated herein by reference to Exhibit (10)(U) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1992.
(10)(W)	Equipment and Supplies Allocation Agreement dated January 1, 1993 between Harleysville Mutual Insurance Company and Harleysville Group Inc. - incorporated herein by reference to Exhibit (10)(V) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1992.
*(10)(X)	Form of Change of Control Employment Agreements dated July 1, 1999 - incorporated herein by reference to Exhibit 10(Z) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1999.
*(10)(Y)	Harleysville Group Inc. Supplemental Retirement Plan Amended and Restated November 17, 1999 - incorporated herein by reference to Exhibit 10(AB) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1999.
*(10)(Z)	1996 Directors' Stock Purchase Plan of Registrant - incorporated herein by reference to Exhibit (4)(C) to the Registrant's Form S-8 Registration Statement No. 333-03127 filed May 3, 1996.

Exhibit No.	Description of Exhibits
* (10)(AA)	Directors Equity Award Program of Registrant - incorporated herein by reference to Exhibit (4)(C) to the Registrant's Form S-8 Registration Statement No. 333-09701 filed August 7, 1996.
* (10)(AB)	Excess Stock Purchase Plan of Registrant - incorporated herein by reference to Exhibit 4.3 to the Registrant's Form S-8 Registration Statement No. 333-37212 filed May 17, 2000.
* (10)(AC)	Long Term Incentive Plan of Registrant - incorporated herein by reference to Exhibit 4.3 to the Registrant's Form S-8 Registration Statement No. 333-37386 filed May 19, 2000.
(13)(A)	Selected Consolidated Financial Data from the Company's 2002 annual report to stockholders.
(13)(B)	Management's Discussion and Analysis of Results of Operations and Financial Condition from the Company's 2002 annual report to stockholders.
(13)(C)	Quantitative and Qualitative Disclosures About Market Risk from the Company's 2002 annual report to stockholders.
(13)(D)	Consolidated financial statements from the Company's 2002 annual report to stockholders.
(13)(E)	Market for Common Stock and Related Security Holder Matters from the Company's 2002 annual report to stockholders.

Exhibit No.	Description of Exhibits
(21)	Subsidiaries of Registrant.
(23)	Independent Auditors' Consent and Report on Schedules.
(99)	Form 11-K Annual Report for the Harleysville Group Inc. Employee Stock Purchase Plan for the year ended December 31, 2002.
(99.1)	Certification of Chief Executive Officer
(99.2)	Certification of Chief Financial Officer

* A management contract, compensatory plan or arrangement required to be separately identified by reason of the provision of Item 14(a)(3).

(b) Reports on Form 8-K

A Form 8-K dated December 16, 2002 was filed disclosing that litigation involving a reinsurance agreement with GE Reinsurance Corporation was settled.

HARLEYSVILLE GROUP

SCHEDULE I - SUMMARY OF INVESTMENTS -
OTHER THAN INVESTMENTS IN RELATED PARTIES

December 31, 2002
(in thousands)

<u>Type of Investment</u>	<u>Cost</u>	<u>Value</u>	<u>Amount at Which Shown in the Balance Sheet</u>
Fixed maturities:			
United States government and government agencies and authorities	\$ 68,289	\$ 75,799	\$ 75,445
States, municipalities and political subdivisions	674,553	720,436	703,558
Mortgage-backed securities	214,453	228,367	228,367
All other corporate bonds	<u>479,747</u>	<u>517,209</u>	<u>502,661</u>
Total fixed maturities	<u>1,437,042</u>	<u>1,541,811</u>	<u>1,510,031</u>
Equity securities:			
Common stocks:			
Banks, trust and insurance companies	22,841	22,104	22,104
Industrial, miscellaneous and all other	<u>74,008</u>	<u>85,073</u>	<u>85,073</u>
Total equities	<u>96,849</u>	<u>107,177</u>	<u>107,177</u>
Short-term investments	<u>89,692</u>		<u>89,692</u>
Total investments	<u>\$1,623,583</u>		<u>\$1,706,900</u>

HARLEYSVILLE GROUP INC.

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

CONDENSED BALANCE SHEETS
(in thousands, except share data)

	December 31,	
	2002	2001
ASSETS		
Short-term investments	\$ 8,652	\$ 6,377
Fixed maturities:		
Available for sale, at fair value (cost \$51 and \$52)	55	53
Investments in common stock of subsidiaries (equity method)	670,814	661,430
Accrued investment income	17	16
Due from affiliate		3,636
Federal income tax recoverable	3,528	
Dividends receivable from subsidiaries	41,965	12,000
Other assets	13,748	14,521
Total assets	\$738,779	\$698,033
LIABILITIES AND SHAREHOLDERS' EQUITY		
Debt	\$ 93,500	\$ 93,500
Accounts payable and accrued expenses	11,963	12,564
Due to affiliate	1,204	
Federal income taxes payable		1,671
Total liabilities	106,667	107,735
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 2002, 30,917,575 and 2001, 30,444,678 shares; outstanding 2002, 29,917,575 and 2001, 29,444,678 shares	30,918	30,445
Additional paid-in capital	149,091	140,065
Accumulated other comprehensive income	49,086	44,265
Retained earnings	418,582	391,088
Treasury stock, at cost, 1,000,000 shares	(15,565)	(15,565)
Total shareholders' equity	632,112	590,298
Total liabilities and shareholders' equity	\$738,779	\$698,033

HARLEYSVILLE GROUP INC.

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

CONDENSED STATEMENTS OF INCOME
(in thousands)

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
Revenues	\$ 7,034	\$ 7,782	\$ 7,631
Expenses:			
Interest	5,649	6,102	6,468
Expenses other than interest	<u>1,793</u>	<u>1,828</u>	<u>1,823</u>
	(408)	(148)	(660)
Income tax benefit	<u>(138)</u>	<u>(46)</u>	<u>(223)</u>
Loss before equity in income of subsidiaries	(270)	(102)	(437)
Equity in income of subsidiaries	<u>46,525</u>	<u>43,595</u>	<u>49,129</u>
Net income	<u>\$46,255</u>	<u>\$43,493</u>	<u>\$48,692</u>

HARLEYSVILLE GROUP INC.

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

CONDENSED STATEMENTS OF CASH FLOWS
(in thousands)

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
Cash flows from operating activities:			
Net income	\$ 46,255	\$ 43,493	\$ 48,692
Adjustments to reconcile net income to net cash used by operating activities:			
Equity in undistributed earnings of subsidiaries	(46,525)	(43,595)	(49,129)
(Increase) decrease in accrued investment income	(1)	19	(16)
Increase (decrease) in accrued income taxes	(5,179)	(2,396)	3,209
Other, net	<u>6,399</u>	<u>1,723</u>	<u>(3,984)</u>
Net cash provided (used) by operating activities	<u>949</u>	<u>(756)</u>	<u>(1,228)</u>
Cash flows from investing activities:			
Purchases of fixed maturity investments		(52)	
Maturities of fixed maturity investments		10	
Net purchases of short-term investments	<u>(2,275)</u>	<u>(34)</u>	<u>(4,646)</u>
Net cash used by investing activities	<u>(2,275)</u>	<u>(76)</u>	<u>(4,646)</u>
Cash flows from financing activities:			
Issuance of common stock	8,051	7,807	6,419
Dividends from subsidiaries	12,036	10,027	20,030
Dividends paid	(18,761)	(17,002)	(15,864)
Purchase of treasury stock			<u>(4,711)</u>
Net cash provided by financing activities	<u>1,326</u>	<u>832</u>	<u>5,874</u>
Change in cash	-	-	-
Cash at beginning of year	<u> </u>	<u> </u>	<u> </u>
Cash at end of year	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

HARLEYSVILLE GROUP
SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION
Years Ended December 31, 2002, 2001 and 2000
(in thousands)

	Deferred Policy Acquisition Costs	Liability for Unpaid Losses and Loss Settlement Expenses	Unearned Premiums	Earned Premiums	Net Investment Income	Losses and Loss Settlement Expenses	Amortization of Deferred Policy Acquisition Costs	Other Underwriting Expenses	Premiums Written
Year ended December 31, 2002									
Commercial lines		\$702,663	\$280,913	\$553,194		\$360,339			\$596,057
Personal lines		154,519	105,942	211,442		161,278			201,793
GAAP adjustments ⁽¹⁾		71,153	19,422						
Total	<u>\$94,896</u>	<u>\$928,335</u>	<u>\$406,277</u>	<u>\$764,636</u>		<u>\$521,617</u>	<u>\$185,547</u>	<u>\$74,105</u>	<u>\$797,850</u>
Net investment income					<u>\$86,265</u>				
Year ended December 31, 2001									
Commercial lines		\$651,088	\$238,050	\$493,362		\$330,943			\$515,860
Personal lines		149,773	115,591	236,527		188,879			231,727
GAAP adjustments ⁽¹⁾		78,195	20,096						
Total	<u>\$86,076</u>	<u>\$879,056</u>	<u>\$373,737</u>	<u>\$729,889</u>		<u>\$519,822</u>	<u>\$180,283</u>	<u>\$64,267</u>	<u>\$747,587</u>
Net investment income					<u>\$85,518</u>				
Year ended December 31, 2000									
Commercial lines		\$635,184	\$215,553	\$437,873		\$302,590			\$446,719
Personal lines		157,400	120,392	250,457		191,084			254,753
GAAP adjustments ⁽¹⁾		72,259	18,153			(873)			
Total	<u>\$84,759</u>	<u>\$864,843</u>	<u>\$354,098</u>	<u>\$688,330</u>		<u>\$492,801</u>	<u>\$177,217</u>	<u>\$60,916</u>	<u>\$701,472</u>
Net investment income					<u>\$86,791</u>				

⁽¹⁾ GAAP adjustments are not determined separately for commercial and personal lines.
See Note 14 of the Notes to Consolidated Financial Statements.

HARLEYSVILLE GROUP

SCHEDULE IV - REINSURANCE

Years Ended December 31, 2002, 2001 and 2000
(in thousands)

	<u>Gross Amount</u>	<u>Ceded to Other Companies</u>	<u>Assumed From Other Companies</u>	<u>Net Amount</u>	<u>Percentage of Amount Assumed to Net</u>
Year ended December 31, 2002 Property and casualty premiums	<u>\$699,482</u>	<u>\$732,487</u>	<u>\$797,641</u>	<u>\$764,636</u>	<u>104.3%</u>
Year ended December 31, 2001 Property and casualty premiums	<u>\$658,166</u>	<u>\$694,643</u>	<u>\$766,366</u>	<u>\$729,889</u>	<u>105.0%</u>
Year ended December 31, 2000 Property and casualty premiums	<u>\$647,300</u>	<u>\$679,770</u>	<u>\$720,800</u>	<u>\$688,330</u>	<u>104.7%</u>

Note: The amounts ceded and assumed include the amounts ceded and assumed under the terms of the pooling arrangement.

HARLEYSVILLE GROUP

SCHEDULE VI - SUPPLEMENTAL INSURANCE INFORMATION CONCERNING
PROPERTY AND CASUALTY SUBSIDIARIES

Years Ended December 31, 2002, 2001 and 2000
(in thousands)

	Liability for Unpaid Losses and Loss Settlement <u>Expenses</u>	Discount, If Any, Deducted from <u>Reserves</u> ⁽¹⁾	Losses and Loss Settlement Expenses (Benefits) Incurred <u>Related to</u>		Paid Losses and Loss Settlement <u>Expenses</u>
			<u>Current Year</u>	<u>Prior Years</u>	
Year ended:					
December 31, 2002	<u>\$928,335</u>	<u>\$9,786</u>	<u>\$526,265</u>	<u>\$ (4,648)</u>	<u>\$465,296</u>
December 31, 2001	<u>\$879,056</u>	<u>\$8,007</u>	<u>\$537,172</u>	<u>\$(17,350)</u>	<u>\$511,545</u>
December 31, 2000	<u>\$864,843</u>	<u>\$7,774</u>	<u>\$541,738</u>	<u>\$(48,937)</u>	<u>\$524,131</u>

- Notes: (1) The amount of discount relates to certain long-term disability workers' compensation cases. A discount rate of 3.5% (5% on New Jersey cases) was used.
- (2) Information required by remaining columns is contained in Schedule III.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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: March , 2003

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ WALTER R. BATEMAN</u> Walter R. Bateman	Chairman of the Board, Chief Executive Officer and a Director	March 26, 2003
<u>/s/ BRUCE J. MAGEE</u> Bruce J. Magee	Senior Vice President and Chief Financial Officer (principal financial officer and principal accounting officer)	March 26, 2003

SIGNATURES
(Continued)

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ LOWELL R. BECK</u> Lowell R. Beck	Director	March 26, 2003
<u>/S/ W. THACHER BROWN</u> W. Thacher Brown	Director	March 26, 2003
<u>/s/ MICHAEL L. BROWNE</u> Michael L. Browne	Director	March 26, 2003
<u>/s/ ROBERT D. BUZZELL</u> Robert D. Buzzell	Director	March 26, 2003
<u>/s/ MIRIAN M. GRADDICK-WEIR</u> Mirian M. Graddick-Weir	Director	March 26, 2003
<u>/s/ JOSEPH E. MCMENAMIN</u> Joseph E. McMenamin	Director	March 26, 2003
<u>/s/ FRANK E. REED</u> Frank E. Reed	Director	March 26, 2003
<u>/s/ JERRY S. ROSENBLOOM</u> Jerry S. Rosenbloom	Director	March 26, 2003

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

I, Walter R. Bateman certify that:

1. I have reviewed this annual report on Form 10-K of Harleysville Group Inc.;

2. Based on my knowledge, this annual 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 annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual 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 annual 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 annual report (the "Evaluation Date"); and

c) presented in this annual 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 annual 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: March 26, 2003

/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 annual report on Form 10-K of Harleysville Group Inc.;

2. Based on my knowledge, this annual 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 annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual 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 annual 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 annual report (the "Evaluation Date"); and

c) presented in this annual 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 annual 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: March 26, 2003

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

EXHIBIT INDEX

Exhibit No.	Description of Exhibits
(13) (A)	Selected Consolidated Financial Data from the Company's 2002 annual report to stockholders.
(13) (B)	Management's Discussion and Analysis of Results of Operations and Financial Condition from the Company's 2002 annual report to stockholders.
(13) (C)	Quantitative and Qualitative Disclosures About Market Risk from the Company's 2002 annual report to stockholders.
(13) (D)	Consolidated financial statements from the Company's 2002 annual report to stockholders.
(13) (E)	Market for Common Stock and Related Security Holder Matters from the Company's 2002 annual report to stockholders.
(21)	Subsidiaries of Registrant.
(23)	Independent Auditors' Consent and Report on Schedules.
(99)	Form 11-K Annual Report for the Harleysville Group Inc. Employee Stock Purchase Plan for the year ended December 31, 2002.
(99.1)	Certification of Chief Executive Officer
(99.2)	Certification of Chief Financial Officer

EXHIBIT 13(A)

Selected Consolidated Financial Data

At December 31, 2002, Harleysville Group Inc. (Company) was approximately 56% owned by Harleysville Mutual Insurance Company (Mutual). Harleysville Group Inc. and its wholly owned subsidiaries (collectively, Harleysville Group) are engaged in property and casualty insurance. These subsidiaries are: Harleysville-Atlantic Insurance Company (Atlantic), Harleysville Insurance Company (HIC), Harleysville Insurance Company of New Jersey (HNJ), Harleysville Insurance Company of New York (HIC New York), Harleysville Insurance Company of Ohio (HIC Ohio), Harleysville Lake States Insurance Company (Lake States), Harleysville Preferred Insurance Company (Preferred), Harleysville Worcester Insurance Company (Worcester), Mid-America Insurance Company (Mid-America), and Harleysville Ltd., a real estate partnership that owns the home office.

	Year Ended December 31,				
	2002	2001	2000	1999	1998
	(in thousands, except per share data)				
Income Statement Data⁽¹⁾:					
Premiums earned	\$ 764,636	\$ 729,889	\$ 688,330	\$ 707,200	\$ 664,604
Investment income, net	86,265	85,518	86,791	85,894	86,025
Realized investment gains (losses)	(18,448)	(3,071)	9,780	16,222	16,085
Total revenues	847,736	827,751	802,571	824,756	779,311
Income before income taxes	56,482	51,800	57,705	47,752	80,441
Income taxes	10,227	8,307	9,013	4,935	17,028
Net income	46,255	43,493	48,692	39,913	63,413
Basic earnings per share	\$ 1.56	\$ 1.49	\$ 1.69	\$ 1.37	\$ 2.18
Diluted earnings per share	\$ 1.53	\$ 1.46	\$ 1.67	\$ 1.35	\$ 2.15
Cash dividends per share	\$.63	\$.58	\$.55	\$.52	\$.48
Balance Sheet Data at Year End:					
Total investments	\$1,706,900	\$1,611,144	\$1,599,125	\$1,604,022	\$1,579,566
Total assets	2,311,524	2,045,290	2,021,862	2,020,056	1,934,497
Debt	95,620	96,055	96,450	96,810	97,140
Shareholders' equity	632,112	590,298	566,581	526,894	529,658
Shareholders' equity per share	\$ 21.13	\$ 20.05	\$ 19.54	\$ 18.29	\$ 18.17

⁽¹⁾ The Company's insurance subsidiaries participate in an underwriting pooling arrangement with Mutual. Harleysville Group's participation was 72% for all years presented. See "Management's Discussion and Analysis of Results of Operations and Financial Condition" and Note 2(a) of the Notes to Consolidated Financial Statements.

EXHIBIT 13(B)

HARLEYSVILLE GROUP

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

Certain of the statements contained herein (other than statements of historical facts) are forward-looking statements. Such forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and include estimates and assumptions related to the Company's growth and 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.

Results of Operations

Harleysville Group underwrites property and casualty insurance in both the personal and commercial lines of insurance. The personal lines of insurance include both auto and homeowners, and the commercial lines include auto, commercial multi-peril and workers compensation. The business is marketed primarily in the eastern and midwestern United States through independent agents.

Historically, Harleysville Group's results of operations have been influenced by factors affecting the property and casualty insurance industry in general. The operating results of the United States property and casualty insurance industry have been subject to significant variations due to competition, weather, catastrophic events, regulation, general economic conditions, judicial trends, fluctuations in interest rates and other changes in the investment environment.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

Harleysville Group's premium growth and underwriting results have been, and continue to be, influenced by market conditions. Insurance industry price competition has often made it difficult both to obtain and to retain properly priced personal and commercial lines business. It is management's policy to maintain its underwriting standards, even at the expense of premium growth.

The key elements of Harleysville Group's business model are the sales of properly priced and underwritten personal and commercial property and casualty insurance through independent agents and the investment of the premiums in a manner that assures claims and expenses can be paid while providing a return on the capital employed. Loss trends and investment performance are critical factors in influencing the success of the business model. These factors are affected by the factors impacting the insurance industry in general as described above and factors unique to Harleysville Group as described in the following discussion.

Transactions with Affiliates

The Company's property and casualty subsidiaries participate in a pooling agreement with Mutual. The pooling agreement provides for the allocation of premiums, losses, loss settlement expenses and underwriting expenses between Harleysville Group and Mutual. Harleysville Group is not liable for any pooled losses occurring prior to January 1, 1986, the date the pooling agreement became effective. Harleysville Group's participation in the pool has been 72% since January 1, 1998.

Because the pooling 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 pooling agreement provides for the right of offset and the net balance of Harleysville Group with Mutual was not material at December 31, 2002 and 2001. Mutual has an A. M. Best rating of "A" (Excellent).

Harleysville Group has off-balance-sheet credit risk related to approximately \$68 million and \$64 million of premium balances due to Mutual from agents and insureds at December 31, 2002 and 2001, respectively. Mutual bills and collects such receivables on behalf of Harleysville Group for efficiency reasons. Harleysville Group recognizes any associated bad debts, which have not been material.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

Transactions with Affiliates (Continued)

Harleysville Group has attempted to reduce the potential impact of future catastrophes by achieving greater geographic distribution of risks, reducing exposure in catastrophe-prone areas and through reinsurance, including an agreement with Mutual. Effective January 1, 1997, Harleysville Group entered into a reinsurance agreement with Mutual whereby Mutual, in return for a reinsurance premium, reinsured accumulated catastrophe losses up to \$14.4 million in a quarter for 2002, 2001 and 2000. This reinsurance coverage was in excess of a retention of \$3.6 million in a quarter for 2002, 2001 and 2000. The agreement excludes catastrophe losses resulting from earthquakes, terrorism or hurricanes, and supplements the existing external catastrophe reinsurance program. Under this agreement, Harleysville Group ceded to Mutual premiums earned of \$7.8 million, \$7.0 million and \$6.8 million, and losses incurred of \$0.3 million, \$8.0 million and \$4.4 million for 2002, 2001 and 2000, respectively. The premiums for this reinsurance were established in consultation with an independent actuarial firm.

Harleysville Ltd. is a subsidiary of the Company and leases the home office to Mutual, which shares the facility with Harleysville Group. Rental income under the lease was \$3.5 million for both 2002 and 2001 and \$3.4 million for 2000 and is included in other income after elimination of intercompany amounts of \$2.2 million in 2002 and \$2.1 million in both 2001 and 2000. The lease has a five-year term expiring December 31, 2004 and includes a formula for additional rent for any additions, improvements or renovations. Mutual is responsible for the building operating expenses including maintenance and repairs. The pricing of the lease was based upon an appraisal obtained from an independent real estate appraiser.

Harleysville Group provides certain management services to Mutual and other affiliates. Harleysville Group received a fee of \$6.8 million, \$7.3 million and \$7.4 million in 2002, 2001 and 2000, respectively, for its services under these management agreements. Under related agreements, Harleysville Group serves as the paymaster for Harleysville companies, with each company being charged for its proportionate share of salary and employee benefits expense based upon time allocation. The level of fees has been approved by each state insurance department having jurisdiction.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

Transactions with Affiliates (Continued)

Intercompany balances are created primarily from the pooling arrangement (settled quarterly), allocation of common expenses, collection of premium balances and payment of claims (settled monthly). No interest is charged or received on intercompany balances due to the timely settlement terms and nature of the items.

Harleysville Group borrowed \$18.5 million from Mutual in connection with the acquisition of Mid-America and HIC New York in 1991. It was a demand loan with a stated maturity in March 1998. In February 1998, the maturity was extended to March 2005 and the interest rate became LIBOR plus 0.65%, which was a commercially reasonable market rate in 1998. Interest expense on this loan was \$0.5 million, \$0.9 million and \$1.3 million in 2002, 2001 and 2000, respectively.

Harleysville Group has no material relationships with current or former members of management other than compensatory plans and arrangements disclosed or described in the Company's public filings.

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). 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.

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 been incurred but 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 incurred but 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

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

Critical Accounting Policies and Estimates (Continued)

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 reviews investments that have experienced a decline in fair value below cost each quarter 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.

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 be consistent with those assessments.

The application of certain of these critical accounting policies to the years ended December 31, 2002 and 2001 is discussed in greater detail below.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

2002 Compared to 2001

Premiums earned increased \$34.7 million, or 5% for the year ended December 31, 2002. The increase was primarily due to an increase in premiums earned for commercial lines of \$59.8 million, or 12%, partially offset by a decrease of \$25.1 million, or 11%, in personal lines premiums earned. The increase in premiums earned for commercial lines primarily was due to higher rates and was partially offset by fewer policy counts. The decline in policy counts was primarily in the workers compensation line of business. The decrease in premiums earned for personal lines primarily was due to fewer policy counts and was partially offset by higher rates. The reduction in personal lines volume was driven primarily by a planned reduction of business in certain less profitable states and the implementation of other more stringent underwriting processes. The trend of double-digit percentage growth in commercial lines premiums earned is expected to continue in 2003 while the decline in personal lines premiums earned is expected to be much lower in 2003 and may turn positive later in 2003.

Investment income increased \$0.7 million, or 1%, for the year ended December 31, 2002, resulting from an increase in invested assets, partially offset by a lower yield on the fixed maturity investment portfolio.

Realized investment losses increased \$15.4 million for the year ended December 31, 2002, primarily due to a \$3.9 million decrease in gains on the sale of fixed maturity securities and an \$11.5 million increase in losses from equity securities.

HARLEYSVILLE GROUP

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

2002 Compared to 2001 (Continued)

During 2002, Harleysville Group recognized other-than-temporary impairment charges as follows:

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
	(in thousands)			
<u>Equity Securities:</u>				
WorldCom	\$2,444	\$ 1,366	\$	\$
AOL Time Warner		3,641		
AT&T		1,358		
AT&T Wireless		1,162		
Bristol-Myers		2,677		
Corning Inc.		1,374		
Solelectron Corp.		1,205		
Sun Microsystems		1,757		
Tyco		2,480		
Williams Cos.		3,559		
Bank of NY			1,273	
EMC Corp.			2,090	
Schering-Plough			1,186	
Household Intl.				<u>670</u>
Total equity securities	<u>2,444</u>	<u>20,579</u>	<u>4,549</u>	<u>670</u>
<u>Fixed Maturities:</u>				
MCI Communications		665		
United Airlines				<u>206</u>
Total fixed maturities		<u>665</u>		<u>206</u>
Total investments	<u>\$2,444</u>	<u>\$21,244</u>	<u>\$4,549</u>	<u>\$876</u>

During the third and fourth quarters, Harleysville Group began to sell equity securities as part of a plan to carry back realized tax losses to recover taxes previously paid. All but two of the equity securities recognized as impaired were sold in a subsequent quarter of 2002.

HARLEYSVILLE GROUP

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

(Continued)

2002 Compared to 2001 (Continued)

Harleysville Group had gross realized equity investment losses of \$28.6 million in 2002, which consisted of impairment charges of \$28.2 million and \$0.4 million from equity securities that were sold. Harleysville Group had gross realized fixed maturity losses of \$2.7 million in 2002, which consisted of impairment charges of \$0.9 million, \$1.8 million from sales of one issuer's bonds with a cost of \$8.3 million that had been below cost for approximately six months at the time of sale.

Harleysville Group evaluates its investment portfolio quarterly to determine if a decline in fair value below cost is other than temporary. Harleysville Group has written down to fair value, without exception, any equity security that has declined below cost by more than 20% and maintained such decline for six months, or by 50% or more, in the quarter in which either such decline occurred. In some cases, securities that have declined by a lesser amount or for a shorter period of time are written down if the evaluation indicates the decline is other than temporary. For example, one equity security had declined for a short period of time but was written down when the sale of the company at a value less than our cost was announced. 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 these are not material.

Harleysville Group holds securities with unrealized losses at December 31, 2002 as follows:

	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Length of Unrealized Loss</u>		
			<u>Less Than 6 Months</u>	<u>6 to 12 Months</u>	<u>Over 12 Months</u>
			(in thousands)		
Equity securities	<u>\$49,886</u>	<u>\$9,871</u>	<u>\$3,439</u>	<u>\$3,351</u>	<u>\$3,081</u>
Fixed maturities:					
Obligations of state and political subdivisions	\$21,064	\$ 256	\$ 256	\$	\$
Corporate bonds	<u>31,655</u>	<u>4,206</u>	<u>35</u>	<u>19</u>	<u>\$4,152</u>
Total bonds	<u>\$52,719</u>	<u>\$4,462</u>	<u>\$ 291</u>	<u>\$ 19</u>	<u>\$4,152</u>

Substantially all of the fixed maturity securities are classified as available for sale and are carried at fair value on the balance sheet.

HARLEYSVILLE GROUP

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

(Continued)

2002 Compared to 2001 (Continued)

There are 24 positions that comprise the unrealized loss in equity investments at December 31, 2002. While 10 of these positions have been below cost for more than six months, they have had volatile price movements and have not been significantly below cost for significant continuous amounts of time. Harleysville Group has been monitoring these securities and it is possible that some may be written down in the income statement in 2003.

There are \$30.3 million in fixed maturity securities, at amortized cost, that at December 31, 2002, had been below amortized cost for over 12 months. These primarily are comprised of airline enhanced equipment trust certificates (EETC) as follows:

	<u>Cost</u>	<u>Fair Value</u>	<u>Maturity Dates</u>
		(in thousands)	
American Airlines	\$14,472	\$12,371	2011
United Airlines	7,012	5,311	2010-2012
Other airlines	2,842	2,693	2011-2015
Other	<u>6,014</u>	<u>5,813</u>	2004-2008
	<u>\$30,340</u>	<u>\$26,188</u>	

After the events of September 11, 2001, air travel and the value of these airlines' EETC securities declined. The EETCs are all "A tranche" holdings, which means they are in a senior credit position to the underlying airplane collateral value as compared to B and C tranche holders. At the time of issuance, the collateral was appraised at approximately twice the value of the A tranche EETCs. At year end, major investment banks had estimated that in a distressed sale scenario, the value of the collateral would be approximately the same as the EETCs' cost. During the fourth quarter of 2002, United Airlines declared bankruptcy. At December 31, 2002, all of the EETCs continued to carry an investment grade rating. In the first quarter of 2003, the debt rating of American Airlines was downgraded by Moody's to non-investment grade. 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 2003, depending upon developments involving both the issuers and the threats of terrorism and war. During the fourth quarter of 2002, a \$0.2 million impairment charge was recognized for United Airlines bonds, which were not EETCs and were not collateralized.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

2002 Compared to 2001 (Continued)

Income before income taxes increased \$4.7 million, or 9%, for the year ended December 31, 2002 due to the higher investment income and a lower underwriting loss, partially offset by the increased realized investment losses.

The 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. Harleysville Group's statutory combined ratio improved to 101.9% for the year ended December 31, 2002 from 104.2% for the year ended December 31, 2001. Such decrease was due to improved results in both commercial lines and personal lines. The commercial lines combined ratio improved to 99.5% for the year ended December 31, 2002 from 100.0% for the year ended December 31, 2001. The personal lines combined ratio improved to 108.1% for the year ended December 31, 2002 from 113.1% for the year ended December 31, 2001. The improvement in commercial lines primarily was due to improved results in the commercial automobile and commercial multi-peril lines of business, partially offset by worse results in the workers compensation line of business, where losses have trended higher. The improvement in personal lines primarily was due to benefits from higher pricing, re-underwriting and agency management efforts, partially offset by higher loss trends in the personal automobile lines. The year ended December 31, 2001 also included estimated losses of \$3.6 million resulting from the September 11, 2001 terrorist acts and a \$2.6 million charge for guaranty fund and other assessments resulting from the liquidation of Reliance Insurance Company. These charges adversely affected the statutory combined ratio by 0.5 points and 0.4 points, respectively.

Losses ceded under the aggregate catastrophe reinsurance agreement with Mutual decreased by \$7.6 million for the year ended December 31, 2002, as there were fewer severe storms than in the prior year.

Harleysville Group recognized favorable development in the provision for insured events of prior years of \$4.6 million and \$17.4 million in 2002 and 2001, respectively. Such development represents 0.6% and 2.2% of the net liability for unpaid losses and loss settlement expenses of \$800.9 million and \$792.6 million

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

2002 Compared to 2001 (Continued)

at December 31, 2001 and 2000, respectively. The favorable development for 2002 primarily related to lower-than-expected claim severity in both the commercial and personal lines of business. The favorable development for 2001 primarily related to lower-than-expected loss settlement expenses.

Of the \$4.6 million of favorable development in 2002, \$2.9 million was from commercial lines and was net of \$6.7 million of favorable development in the 2001 accident year and \$4.8 million of adverse development in the 1999 accident year and smaller amounts of development in every other accident year. The net liability for commercial lines unpaid losses and loss settlement expenses at December 31, 2001 for the 2001 and 1999 accident years was \$236.2 million and \$91.9 million, respectively. Favorable development in personal lines was \$1.7 million for 2002 and was net of \$3.8 million of favorable development in the 2001 accident year and \$0.9 million of adverse development in the 1998 accident year and smaller amounts of development in every other accident year. The net liability for personal lines unpaid losses and loss settlement expenses at December 31, 2001 for the 2001 and 1998 accident years was \$71.5 million and \$11.7 million, respectively. Actuarial loss reserving techniques and assumptions, which rely on historical information as adjusted to reflect current conditions, have been consistently applied during the periods presented. Changes in the estimate of the liability for unpaid losses and loss settlement expenses were not actuarially significant and reflect actual payments and evaluations of new information and data since the last reporting date. These changes correlate with actuarial trends and primarily relate to lower-than-expected claim severity.

Of the \$17.4 million of favorable development in 2001, \$14.8 million was derived from a reduction in anticipated loss settlement expenses. During 2000, Harleysville Group completed a plan to consolidate its claims operations from 23 general claims offices into a centralized direct reporting center and four specialized regional claims centers, which resulted in the termination of 173 employees. At December 31, 2000, the liability for loss settlement expenses of \$151.0 million was established based on historical trends with consideration given to benefits from staffing reductions that were expected from the claims reorganization. When establishing this liability, Harleysville Group did not have historical experience or data regarding such a reorganization that indicated that additional benefits were likely to be realized. During 2001, the actual loss settlement payments and actuarial data indicated, with increasing certainty, that the benefits from the claims reorganization were greater than originally anticipated due to the benefits of

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

2002 Compared to 2001 (Continued)

greater specialization of the staff and the favorable development was recognized throughout 2001 as the experience developed. Of the \$14.8 million favorable development from loss settlement expenses, \$13.5 million is from commercial lines and is from all of the accident years roughly in proportion to the loss reserves in those accident years. In addition to the \$14.8 million of favorable loss settlement expense development, there was \$2.6 million of net favorable loss development with no significant variances from a varied mix of accident years and lines.

The net liability at December 31, 2002 for unpaid losses and loss settlement expenses was \$702.7 million for commercial lines and \$154.5 million for personal lines. Harleysville Group has recorded the actuarial best estimate of the ultimate unpaid cost of all losses and loss settlement expenses incurred, including losses for claims that have been incurred but 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. A statistically determined range of estimates for commercial lines is \$616.4 million to \$822.1 million and for personal lines is \$129.7 million to \$176.4 million. The range of estimates around the actuarial best estimates is statistically determined in order to provide information regarding the variability of the actuarial best estimates. The ranges were determined using both paid and incurred loss development data with a 1,000 trial simulation run against each set of data. Development factors within each 12-month development period were assumed to be normally distributed with the means equal to the estimated age-to-age factors, and the standard deviations equal to the actual standard deviations of the data used. The resulting ranges produced by the simulation were then used to create a reasonable representation of a 90% confidence interval using the 5% point as the low end of the range and the 95% point as the high end of the range.

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

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

2002 Compared to 2001 (Continued)

As a result, more recent statistical data reflects different patterns than in the past. For example, the rate of settlement of liability cases is generally slower than it had been before the reorganization. Harleysville Group believes that this reflects the impact of more specialized claims settlement activity and a related increase in litigation and has considered this in establishing its best estimates. On the other hand, smaller, routine property claims are being handled by a centralized claims unit that has led to faster settlement of such claims. These changes resulting from the claims reorganization give rise to uncertainty as to the pattern of future loss settlements. There are uncertainties regarding future loss cost trends particularly related to medical treatments and automobile repair. Court decisions, regulatory changes and economic conditions can affect the ultimate cost of claims that occurred in the past. Accordingly, the ultimate liability for unpaid losses and loss settlement expenses is likely to differ from the amount recorded at December 31, 2002. For every 1% change in the estimate, the effect on pre-tax income would be \$8.6 million.

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

Effective for one year from July 1, 2002, the pool in which Harleysville Group and Mutual participate is reinsured under a catastrophe reinsurance treaty that provides coverage ranging from 84.8% to 94.3% of up to \$140 million in excess of a retention of \$30 million for any given catastrophe. Harleysville Group's 2002 pooling share of this coverage would range from 84.8% to 94.3% of up to \$100.8 million in excess of a retention of \$21.6 million for any given catastrophe. Accordingly, pursuant to the terms of the treaty, the maximum recovery would be \$126.5 million for any catastrophe involving an insured loss of \$170 million or greater. Harleysville Group's 2002 pooling share of this maximum recovery would be \$91.1 million for any catastrophe involving an insured loss of \$122.4 million or greater. The treaty includes reinstatement provisions for coverage for a second catastrophe and payment of an additional premium in the event of a first catastrophe occurring. Most terrorism losses would not be covered by the treaty. A separate property per risk reinsurance treaty covers certain terrorism losses. The maximum recovery by Harleysville Group on such terrorism losses would be \$27 million.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**
(Continued)**2001 Compared to 2000**

Premiums earned increased \$41.6 million, or 6%, for the year ended December 31, 2001. The increase was due to an increase in premiums earned for commercial lines of \$55.5 million, partially offset by a decrease of \$13.9 million in personal lines premiums earned. The increase in premiums earned for commercial lines primarily was due to higher rates, partially offset by fewer policy counts. The decrease in premiums earned for personal lines primarily was due to fewer policy counts, partially offset by higher rates.

Investment income decreased \$1.3 million, or 1%, for the year ended December 31, 2001 due to a lower yield on the investment portfolio.

Realized investment gains (losses) decreased \$12.9 million for the year ended December 31, 2001 primarily resulting from greater losses on the sale of equity securities and an increase of \$5.5 million in losses recognized on investments that were trading below cost on an other-than-temporary basis. Such increased losses were partially offset by greater gains on the sale of fixed maturities.

Income before income taxes decreased \$5.9 million, or 10%, for the year ended December 31, 2001, due to the lower investment income and lower realized investment gains (losses), partially offset by a lower underwriting loss. Harleysville Group's statutory combined ratio improved to 104.2% for the year ended December 31, 2001 from 106.1% for the year ended December 31, 2000. Such decrease is primarily due to improved results in commercial lines, partially offset by worse results in personal lines. The commercial lines combined ratio improved to 100.0% for the year ended December 31, 2001 from 104.5% for the year ended December 31, 2000. The personal lines combined ratio declined to 113.1% for the year ended December 31, 2001 from 108.7% for the year ended December 31, 2000. The improvement in commercial lines primarily was due to benefits from higher pricing, re-underwriting and agency management efforts, partially offset by \$3.6 million of net estimated losses (\$.08 per basic share after taxes) resulting from the September 11, 2001 terrorist acts. The decline in personal lines profitability primarily was due to higher loss trends in the personal automobile lines.

The year ended December 31, 2001 included a \$2.6 million charge (\$.06 per basic share after taxes) for guaranty fund and other assessments resulting from the liquidation of Reliance Insurance Company. This charge adversely affected the statutory

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**

(Continued)

2001 Compared to 2000 (Continued)

combined ratio by 0.4 points and the September 11 terrorist losses adversely affected it by 0.5 points. The year ended December 31, 2000 included a pre-tax charge of \$1.1 million (\$.03 per basic share after taxes) related to the consolidation of selected non-claims support services and office functions throughout the field operations. This restructuring charge adversely affected the statutory combined ratio by 0.2 points for the year ended December 31, 2000. Income before income taxes for the year ended December 31, 2000 also was reduced by \$1.9 million (\$.04 per basic share after taxes) to reflect the effect of a settlement of litigation between the North Carolina Rate Bureau and the Commissioner of Insurance over personal automobile insurance rate levels dating back to 1994. The settlement, which mandated a refund of premium be made to policyholders, adversely affected the combined ratio by 0.3 points.

Losses ceded under the aggregate catastrophe reinsurance agreement with Mutual increased by \$3.6 million for the year ended December 31, 2001, as there were more severe storms, particularly in the Midwest, than in the prior year.

Harleysville Group recognized \$48.9 million of favorable development in the provision for insured events of prior years in 2000, of which \$20.2 million was from loss settlement expenses and \$28.7 million is from losses. At December 31, 1999, the liability for loss settlement expenses of \$158.5 million was established based on historical trends. The aforementioned claims reorganization plan was being implemented and was not complete at that time. As a result, Harleysville Group was unable to accurately estimate the benefits to the ultimate loss settlement expenses associated with claims that occurred prior to December 31, 1999. During 2000, the claims reorganization was completed and staffing efficiencies were achieved and the estimate of the liability for loss settlement expenses was adjusted in correlation with this information.

Of the \$28.7 million of favorable loss development in 2000, \$21.0 million was from commercial lines and \$7.7 million was from personal lines. For both of these lines, the favorable development correlated with actuarial trends and primarily was in the three most recent accident years. Within the commercial lines, workers compensation claims developed favorably by \$8.9 million primarily due to benefits of reform legislation that was passed in Pennsylvania and resulted in a reduction of medical cost trends from rules that controlled medical fees and a reduction in indemnity costs through rules that resulted in injured workers returning to work quicker. Such benefits affected almost all accident years.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**
(Continued)**New Accounting Standards**

In June 2001, SFAS No. 142, "Goodwill and Other Intangible Assets" was issued. SFAS 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 SFAS No. 142. Harleysville Group adopted the provisions of SFAS No. 142 effective January 1, 2002, at which time Harleysville Group ceased to record amortization expense related to its goodwill. The adoption of SFAS No. 142 resulted in a \$0.8 million reduction in amortization expense in 2002 as compared to 2001. Harleysville Group's goodwill balance was \$23.4 million at December 31, 2002. Harleysville Group completed its analysis of any potential impairment of the goodwill during the second quarter of 2002 and no adjustment was necessary.

Other new accounting standards that have been issued did not, or are not expected to, have a material impact on the consolidated financial statements.

Liquidity and Capital Resources

Liquidity is a measure of the ability to generate sufficient cash to meet cash obligations as they come due. Harleysville Group's primary sources of cash are premium income, investment income and maturing investments. Cash outflows can be variable because of uncertainties regarding settlement dates for liabilities for unpaid losses and because of the potential for large losses, either individually or in the aggregate. Accordingly, Harleysville Group maintains investment and reinsurance programs generally intended to provide adequate funds to pay claims without forced sales of investments. Harleysville Group models its exposure to catastrophes and has the ability to pay claims without selling held to maturity securities even for events having a low (less than 1%) probability. Even in years of greater catastrophe frequency, Harleysville Group has been able to pay claims without liquidating any investments. Harleysville Group has also considered scenarios of declines in revenue and increases in loss payments, and has the ability to meet cash requirements under such scenarios without selling held to maturity securities. Harleysville Group's policy with respect to fixed maturity investments is to purchase only those that are of investment grade quality.

Net cash provided by operating activities was \$113.2 million and \$45.8 million for 2002 and 2001, respectively. The increase in net cash provided by operating activities primarily consists of an increase in cash provided by underwriting activities.

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

Liquidity and Capital Resources (Continued)

Net cash used by investing activities was \$100.9 million and \$36.4 million for 2002 and 2001, respectively. The change is primarily due to increased net purchases of investments due to the increase in cash provided by operating activities.

Financing activities used net cash of \$11.1 million in 2002 compared to \$9.6 million in 2001. The change was 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 period of time in return for a fee. At December 31, 2002, Harleysville Group held cash collateral of \$139.2 million related to securities on loan with a market value of \$135.5 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 GICs and Funding Agreements from issuers rated "A" or better.

The Company had \$8.7 million of cash and marketable securities and \$42.0 million of dividends receivable from its subsidiaries at December 31, 2002, which are available for general corporate purposes including dividends, debt service, capital contributions to subsidiaries, acquisitions and the repurchase of stock. The Company's \$75.0 million of notes payable are due in November 2003 and are expected to be refinanced. The Company has adopted a stock repurchase plan under which the Company may purchase up to 500,000 shares of Harleysville Group Inc. common stock. Mutual has authorized purchases of the common shares of Harleysville Group Inc. in an equal amount. At March 6, 2003, the Company and Mutual each have repurchased 1,250 of the shares authorized to be repurchased. Harleysville Group has no material commitments for capital expenditures as of December 31, 2002.

As a holding company, the Company's principal source of cash for the payment of dividends is dividends from its subsidiaries. The Company's insurance subsidiaries are subject to state laws that restrict their ability to pay dividends.

HARLEYSVILLE GROUP

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

Liquidity and Capital Resources (Continued)

Applying the current regulatory restrictions as of December 31, 2002, \$11.0 million would be available for distribution to the Company by its subsidiaries without prior regulatory approval until October 1, 2003, after which \$52.9 million would be available for distribution to Harleysville Group Inc. without prior approval. See the Business-Regulation section of the Company's 2002 Form 10-K, which includes a reconciliation of net income and shareholders' equity as determined under statutory accounting practices to net income and shareholders' equity as determined in accordance with generally accepted accounting principles. Also, see Note 10 of the Notes to Consolidated Financial Statements.

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

The NAIC has adopted the Codification of Statutory Accounting Principles with an effective date of January 1, 2001. The codified principles are intended to provide a basis of accounting recognized and adhered to in the absence of, conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the January 1, 2001 statutory capital and surplus of the Company's insurance subsidiaries ranged from a decrease of \$0.4 million to an increase of \$6.4 million and was an increase of \$21.0 million on a consolidated basis.

Harleysville Group had off-balance-sheet credit risk related to \$68.0 million of premium balances due to Mutual from agents and insureds at December 31, 2002.

The following summarizes Harleysville Group's contractual obligations at December 31, 2002.

	<u>Total</u>	<u>Less Than 1 Year</u>	<u>1-3 Years</u>	<u>After 3 Years</u>
		(in thousands)		
Contractual obligations:				
Debt	\$95,620	\$75,475	\$19,585	\$560

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition
(Continued)****Liquidity and Capital Resources (Continued)**

In 2001, GE Reinsurance Corporation (GE Re) sought rescission 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. On December 13, 2002, Mutual and GE Re settled this matter by agreeing to a commutation and termination of the reinsurance agreement effective December 31, 2002. The settlement agreement did not materially impact Harleysville Group's financial statements.

Impact of Inflation

Property and casualty insurance premiums are established before the amount of losses and loss settlement expenses, or the extent to which inflation may affect such expenses, are known. Consequently, Harleysville Group attempts, in establishing rates, to anticipate the potential impact of inflation. In the past, inflation has contributed to increased losses and loss settlement expenses.

Risk Factors

You should consider carefully the following risks, as well as the other information contained in our 2002 Report on Form 10-K. If any of the following risks actually occur, our business, financial condition and results of operations could be adversely affected. You should refer to the other information set forth in our 2002 Report on Form 10-K including our consolidated financial statements and the related notes.

Our reserves may not be adequate to cover our ultimate liability for losses and loss settlement expenses.

We are required to maintain loss reserves for our estimated liability for losses and loss settlement expenses associated with reported and unreported claims for each accounting period. We regularly review our reserving techniques and our overall amount of reserves and, based on our estimated liability, raise or lower the levels of our reserves accordingly. If our estimates are incorrect and our reserves are inadequate, we are obligated to increase our reserves. An increase in reserves results in an increase in losses and a reduction in our net income for the period in which the deficiency in reserves is identified. Accordingly, an increase in reserves could have a material adverse effect on our results of operations, liquidity and

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**
(Continued)**Risk Factors (Continued)**

financial condition. Our reserve amounts are estimated based on what we expect our ultimate liability for losses and loss settlement expenses to be. These estimates are based on facts and circumstances of which we are aware, predictions of future events, trends in claims severity and frequency and other subjective factors. Although we use a number of methods to project our ultimate liability, there is no method that can always exactly predict our ultimate liability for losses and loss settlement expenses.

In addition to reviewing our reserving techniques, as part of our reserving process we also consider:

- □ information regarding each claim for losses;
- □ our loss history and the industry's loss history;
- □ legislative enactments, judicial decisions and legal developments regarding damages;
- □ changes in political attitudes; and
- □ trends in general economic conditions, including inflation.

We cannot be certain that the reserves we establish are adequate now or will be adequate in the future.

Catastrophic events can have a significant impact on our financial and operational condition.

Results of property insurers are subject to weather and other events prevailing in any given year. While one year may be relatively free of major weather or other disasters, another year may have numerous such events causing results for that year to be materially worse than for other years.

Our insurance subsidiaries have experienced, and are expected in the future to experience, catastrophe losses. It is possible that a catastrophic event or a series of multiple catastrophic events could have a material adverse effect on the operating results and financial condition of our insurance subsidiaries, thereby limiting the ability of our insurance subsidiaries to pay dividends to us.

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

Risk Factors (Continued)

Various events can cause catastrophes, including severe winter weather, hurricanes, windstorms, earthquakes, hail, terrorism, explosions and fires. The frequency and severity of these catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposures in the area affected by the event and the severity of the event.

Our insurance subsidiaries seek to reduce the impact on our business of a catastrophe through geographic diversification and through the purchase of reinsurance covering various categories of catastrophes, which generally excludes terrorism. Nevertheless, reinsurance may prove inadequate if:

- □ a major catastrophic loss exceeds the reinsurance limit, or
- □ an insurance subsidiary pays a number of smaller catastrophic loss claims that, individually, fall below the subsidiary's retention level.

We face significant competition from other regional and national insurance companies, agents and from self-insurance.

We compete with local, regional and national insurance companies, including direct writers of insurance coverage. Many of these competitors are larger than we are and many have greater financial, technical and operating resources. In addition, we face competition within each insurance agency that sells our insurance because we sell through independent agencies that represent more than one insurance company.

The property and casualty insurance industry is highly competitive on the basis of product, price and service. If our competitors offer products with more coverage, or price their products more aggressively, our ability to grow or renew our business may be adversely impacted. There are many companies competing for the same insurance customers in the geographic areas in which we operate. The internet also could emerge as a significant source of new competition, both from existing competitors using their brand name and resources to write business through this new distribution channel and from new competitors.

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
of Operations and Financial Condition**
(Continued)**Risk Factors (Continued)**

We also face competition because of entities that self-insure, primarily in the commercial insurance market. From time to time, certain of our customers and potential customers may examine the benefits and risks of self-insurance and other alternatives to traditional insurance.

A number of new, proposed or potential legislative or industry developments could further increase competition in the property and casualty insurance industry. These developments include:

- □ the enactment of the Gramm-Leach-Bliley Act of 1999, which could result in increased competition from new entrants to the insurance market, including banks and other financial service companies;
- □ programs in which state-sponsored entities provide property insurance in catastrophe-prone areas or other alternative market types of coverage; and
- □ changing practices caused by the internet, which have led to greater competition in the insurance business and, in some cases, greater expectations for customer service.

New competition from these developments could cause the supply or demand for insurance to change, which could adversely affect our results of operations and financial condition.

We are heavily regulated in the states in which we operate.

We are subject to extensive supervision and regulation in the states in which we transact business. The primary purpose of supervision and regulation is to protect individual policyholders and not shareholders or other investors. Our business can be adversely affected by private passenger automobile insurance regulations and any other regulations affecting property and casualty insurance companies. For example, laws and regulations can reduce or set rates at levels that we do not believe are adequate for the risks we insure. Other laws and regulations can limit our ability to cancel or refuse to renew policies and require us to offer coverage to all consumers. Changes in laws and regulations, or their interpretations, pertaining to insurance, including workers compensation, may also have an adverse effect on our business. Although the federal government does not directly regulate the insurance industry, federal initiatives, such as federal terrorism backstop legislation, from time to time, also can impact the insurance industry.

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

Risk Factors (Continued)

In addition, proposals intended to control the cost and availability of health care services have been debated in the U.S. Congress and state legislatures. Although we do not write health insurance, rules affecting health care services can affect other insurance that we write, including workers compensation, and commercial and personal automobile and liability insurance. We cannot determine whether or in what form health care reform legislation may be adopted by the U.S. Congress or any state legislature. We also cannot determine the nature and effect, if any, that the adoption of health care legislation or regulations, or changing interpretations, at the federal or state level would have on us.

The property and casualty insurance industry is cyclical.

Historically, the results of the property and casualty insurance industry have been subject to significant fluctuations over time due to competition and due to unpredictable developments, including:

- ☐ natural and man-made disasters;
- ☐ fluctuations in interest rates and other changes in the investment environment that affect returns on our investments;
- ☐ inflationary pressures that affect the size of losses; and
- ☐ legislative and regulatory changes and judicial decisions that affect insurers' liabilities.

The demand for property and casualty insurance, particularly commercial lines, also can vary with the overall level of economic activity. In addition to the cyclicity of the property and casualty industry, our surety business is affected adversely by economic downturns that make it difficult for the insureds whose obligations we guarantee to fulfill their obligations.

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

Risk Factors (Continued)

Our ability to reduce our exposure to risks depends on the availability and cost of reinsurance.

We transfer a portion of our exposure to selected risks to other insurance and reinsurance companies through reinsurance arrangements. Under our reinsurance arrangements, another insurer assumes a specified portion of our losses and loss adjustment expenses in exchange for a specified portion of policy premiums. The availability, amount and cost of reinsurance depend on market conditions and may vary significantly. Any decrease in the amount of our reinsurance will increase our risk of loss. Furthermore, we face a credit risk when we obtain reinsurance because we are still liable for the transferred risks if the reinsurer cannot meet the transferred obligations. Therefore, the inability of any of our reinsurers to meet its financial obligations could materially and adversely affect our operations.

Many reinsurers experienced significant losses related to the terrorist acts of September 11, 2001, and future terrorist acts may have similar effects. As a result, we may incur significantly higher reinsurance costs and more restrictive terms and conditions, or may be unable to attain reinsurance for some types of commercial exposures.

Our performance is tied to the economic and regulatory conditions and weather-related events in the eastern and midwestern United States.

We write property and casualty insurance business in the eastern and midwestern United States. Consequently, unusually severe storms or other natural or man-made disasters that destroy property in these states could adversely affect our operations. Our revenues and profitability also are subject to prevailing economic and regulatory conditions in the states in which we write insurance. We may be exposed to risks of adverse developments that are greater than if we conducted business nationwide.

We depend on our investments to support our operations and to provide a significant portion of our revenues and earnings.

We, like many other property and casualty insurance companies, depend on income from our investment portfolio for a significant portion of our revenues and earnings. Any significant decline in our investment income as a result of

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

Risk Factors (Continued)

falling interest rates, decreased dividend payment rates or general market conditions would have an adverse effect on our results. Any significant decline in the market value of our investments would reduce our shareholders' equity and our policyholders' surplus, which could impact our ability to write additional business.

We depend on independent insurance agents.

We market and sell our insurance products through independent, non-exclusive insurance agencies. These agencies are not obligated to sell our insurance products, and generally they also sell our competitors' insurance products. As a result, our business depends in part on the marketing and sales efforts of these agencies. If we diversify and expand our business geographically, then we may need to expand our network of agencies to successfully market our products. If these agencies fail to market our products successfully, our business may be adversely impacted. Also, independent agents may decide to sell their businesses to banks, other insurance agencies or other businesses. Changes in ownership of agencies, or expansion of agencies through acquisition, could adversely affect an agency's ability to control growth and profitability, thereby adversely affecting our business.

We may be adversely impacted by a change in our rating.

Insurance companies are subject to financial strength ratings produced by external rating agencies. Higher ratings generally indicate financial stability and a strong ability to pay claims. Ratings are assigned by rating agencies to insurers based upon factors that they believe are relevant to policyholders. Ratings are not recommendations to buy, hold or sell our securities.

The principal agencies that cover the property and casualty industry are A.M. Best Company, Standard & Poor's and Moody's. We believe our ability to write business is most influenced by our rating from A.M. Best. According to A.M. Best, its ratings are designed to assess an insurer's financial strength and ability to meet ongoing obligations to policyholders. A rating below "A-" from A.M. Best could materially adversely affect the business we write. We believe that ratings from Standard & Poor's or Moody's, although important, have less of an impact on our

HARLEYSVILLE GROUP**Management's Discussion and Analysis of Results
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(Continued)**Risk Factors (Continued)**

business. An unfavorable change in either of these ratings, however, could make it more expensive for us to access capital markets. We cannot be sure that we will maintain our current A.M. Best, Standard & Poor's or Moody's ratings.

Because we are an insurance holding company, we rely on receiving adequate dividends from our insurance subsidiaries.

Our principal assets are the shares of capital stock of our insurance company subsidiaries. We rely on dividends from our insurance company subsidiaries to meet our obligations for paying principal and interest on outstanding debt obligations and for paying corporate expenses and dividends to shareholders. The payment of dividends by our insurance company subsidiaries is subject to regulatory restrictions and will depend on the surplus and future earnings of these subsidiaries, as well as other regulatory restrictions. As a result, we may not be able to receive dividends from these subsidiaries at times and in amounts necessary to meet our obligations or to allow us to pay dividends.

Applicable insurance laws make it difficult to effect a change of control, and a large shareholder may have significant influence over potential change of control transactions.

Under applicable insurance laws and regulations of the states in which our subsidiaries are domiciled, no person may acquire control of us unless that person has filed a statement containing specified information with the insurance commissioner of each state and obtains advance approval for such acquisition. Under applicable laws and regulations, any person acquiring, directly or indirectly (by revocable proxy or otherwise), 10% or more of the voting stock of any other person is presumed to have acquired control of such person, and a person who beneficially acquires 10% or more of our common stock without obtaining advance approval of the insurance commissioner of each state would be in violation of applicable insurance laws and would be subject to injunctive action requiring disposition or seizure of the shares and prohibiting the voting of such shares, as well as other action determined by the insurance commissioner of each such state.

In addition, many state insurance laws require prior notification to the state insurance department of a change of control of a non-domiciliary insurance company licensed to transact insurance in that state. Although these pre-

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

Risk Factors (Continued)

notification statutes do not authorize the state insurance departments to disapprove the change of control, they authorize regulatory action - including a possible revocation of our authority to do business - in the affected state if particular conditions exist such as undue market concentration. Any future transactions that would constitute a change of control of us may require prior notification in the states that have pre-acquisition notification laws.

As of December 31, 2002, Mutual owned approximately 56% of our outstanding common stock. Mutual's stock ownership and ability, by reason of such ownership, to elect our board of directors, provides it with significant influence over potential change of control transactions.

Finally, our certificate of incorporation permits the Board of Directors to issue up to one million shares of preferred stock having such terms, including voting rights, as the Board shall fix and determine.

We depend on key personnel.

The success of our business is dependent, to a large extent, on our ability to attract and retain key employees, in particular our senior officers, and key management, sales, information systems, underwriting, claims and corporate personnel. Competition to attract and retain key personnel is intense. Although we have change of control agreements with a number of key managers, in general we do not have employment contracts or non-compete arrangements with our employees, including our key employees.

EXHIBIT 13(C)

HARLEYSVILLE GROUP**Quantitative and Qualitative Disclosure About Market Risk****Interest Rate Risk**

Harleysville Group's exposure to market risk for changes in interest rates is concentrated in its investment portfolio and, to a lesser extent, its debt obligations. Harleysville Group monitors this exposure through periodic reviews of asset and liability positions. Estimates of cash flows and the impact of interest rate fluctuations relating to the investment portfolio are modeled regularly.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates are as follows:

	<u>December 31, 2002</u>	
	<u>Principal Cash Flows</u>	<u>Weighted-Average Interest Rate</u>
	(dollars in thousands)	
Fixed maturities and short-term investments:		
2003	\$ 279,888	4.48%
2004	138,912	6.24%
2005	173,976	6.20%
2006	237,249	5.74%
2007	164,395	5.87%
Thereafter	<u>527,504</u>	5.73%
Total	<u>\$1,521,924</u>	
Fair value	<u>\$1,631,503</u>	
Debt		
2003	\$ 75,475	6.72%
2004	520	1.70%
2005	19,065	2.04%
2006	<u>560</u>	1.70%
Total	<u>\$ 95,620</u>	
Fair value	<u>\$ 96,689</u>	

Actual cash flows may differ from those stated as a result of calls and prepayments.

HARLEYSVILLE GROUP**Quantitative and Qualitative Disclosures About Market Risk**
(Continued)**Equity Price Risk**

Harleysville Group's portfolio of equity securities, which is carried on the balance sheet at fair value, has exposure to price risk. Price risk is defined as the potential loss in fair value resulting from an adverse change in prices. Portfolio characteristics are analyzed regularly and market risk is actively managed through a variety of techniques. The portfolio is diversified across industries, and concentrations in any one company or industry are limited by parameters established by senior management.

The combined total of realized and unrealized equity investment losses was \$48.7 million, \$35.9 million and \$12.2 million in 2002, 2001 and 2000, respectively. During these three years, the largest total equity investment gain and (loss) in a quarter was \$14.6 million and \$(29.1) million, respectively.

EXHIBIT 13(D)

HARLEYSVILLE GROUP
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	December 31,	
<u>Assets</u>	2002	2001
Investments:		
Fixed maturities:		
Held to maturity, at amortized cost (fair value \$411,235 and \$459,588)	\$ 379,940	\$ 439,499
Available for sale, at fair value (cost \$932,889 and \$956,047)	995,032	984,264
Equity securities, at fair value (cost \$96,849 and \$110,803)	107,177	150,686
Short-term investments, at cost, which approximates fair value	89,692	36,695
Fixed maturity securities on loan:		
Held to maturity, at amortized cost (fair value \$5,707)	5,222	
Available for sale, at fair value (amortized cost \$118,991)	129,837	
Total investments	1,706,900	1,611,144
Cash	2,944	1,839
Receivables:		
Premiums	138,905	122,508
Reinsurance	75,488	81,640
Accrued investment income	21,552	21,862
Total receivables	235,945	226,010
Deferred policy acquisition costs	94,896	86,076
Prepaid reinsurance premiums	19,421	20,096
Property and equipment, net	27,556	28,873
Deferred income taxes	25,784	29,435
Security lending collateral	139,215	
Due from affiliate	10,709	
Other assets	48,154	41,817
Total assets	\$2,311,524	\$2,045,290
<u>Liabilities and Shareholders' Equity</u>		
Liabilities:		
Unpaid losses and loss settlement expenses	\$ 928,335	\$ 879,056
Unearned premiums	406,277	373,737
Accounts payable and accrued expenses	109,965	96,440
Security lending obligation	139,215	
Debt	95,620	96,055
Due to affiliate	9,704	9,704
Total liabilities	1,679,412	1,454,992
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 2002, 30,917,575 and 2001, 30,444,678 shares; outstanding 2002, 29,917,575 and 2001, 29,444,678 shares	30,918	30,445
Additional paid-in capital	149,091	140,065
Accumulated other comprehensive income	49,086	44,265
Retained earnings	418,582	391,088
Treasury stock, at cost, 1,000,000 shares	(15,565)	(15,565)
Total shareholders' equity	632,112	590,298
Total liabilities and shareholders' equity	\$2,311,524	\$2,045,290

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data)

	<u>Year Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
Revenues:			
Premiums earned	\$764,636	\$729,889	\$688,330
Investment income, net of investment expense	86,265	85,518	86,791
Realized investment gains (losses)	(18,448)	(3,071)	9,780
Other income	<u>15,283</u>	<u>15,415</u>	<u>17,670</u>
Total revenues	<u>847,736</u>	<u>827,751</u>	<u>802,571</u>
Expenses:			
Losses and loss settlement expenses	521,617	519,822	492,801
Amortization of deferred policy acquisition costs	185,547	180,283	177,217
Other underwriting expenses	74,105	64,267	60,916
Interest expense	5,698	6,207	6,612
Other expenses	<u>4,287</u>	<u>5,372</u>	<u>7,320</u>
Total expenses	<u>791,254</u>	<u>775,951</u>	<u>744,866</u>
Income before income taxes	56,482	51,800	57,705
Income taxes	<u>10,227</u>	<u>8,307</u>	<u>9,013</u>
Net income	<u>\$ 46,255</u>	<u>\$ 43,493</u>	<u>\$ 48,692</u>
Per common share:			
Basic earnings	<u>\$ 1.56</u>	<u>\$ 1.49</u>	<u>\$ 1.69</u>
Diluted earnings	<u>\$ 1.53</u>	<u>\$ 1.46</u>	<u>\$ 1.67</u>
Cash dividends	<u>\$.63</u>	<u>\$.58</u>	<u>\$.55</u>

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
For the years ended December 31, 2002, 2001 and 2000
(dollars in thousands)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>					
Balance at December 31, 1999	29,498,651	\$29,499	\$124,798	\$ 51,682	\$331,769	\$(10,854)	\$526,894
Net income					48,692		48,692
Other compre- hensive income, net of tax:							
Unrealized investment gains, net of reclassification adjustment				4,328			<u>4,328</u>
Comprehensive income							<u>53,020</u>
Issuance of common stock:							
Incentive plans	466,068	466	5,279				5,745
Dividend Reinvestment Plan	37,133	37	637				674
Tax benefit from stock options exercised			823				823
Cash dividends paid					(15,864)		(15,864)
Purchase of treasury stock, 313,435 shares						(4,711)	(4,711)
Balance at December 31, 2000	30,001,852	30,002	131,537	56,010	364,597	(15,565)	566,581
Net income					43,493		43,493
Other compre- hensive income, net of tax:							
Unrealized investment losses, net of reclassification adjustment				(11,745)			<u>(11,745)</u>
Comprehensive income							<u>31,748</u>
Issuance of common stock:							
Incentive plans	413,528	414	6,708				7,122
Dividend Reinvestment Plan	29,298	29	656				685
Tax benefit from stock options exercised			1,164				1,164
Cash dividends paid					(17,002)		(17,002)
Balance at December 31, 2001	30,444,678	30,445	140,065	44,265	391,088	(15,565)	590,298

(Continued)

HARLEYSVILLE GROUP
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Continued)

For the years ended December 31, 2002, 2001 and 2000
(dollars in thousands)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Retained Earnings</u>	<u>Treasury Stock</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>					
Net income		\$	\$	\$	\$ 46,255	\$	\$ 46,255
Other compre- hensive income, net of tax:							
Unrealized investment gains, net of reclassification adjustment				9,891			9,891
Minimum pension liability adjustment				(5,070)			<u>(5,070)</u>
Other compre- hensive income							<u>4,821</u>
Comprehensive income							<u>51,076</u>
Issuance of common stock:							
Incentive plans	446,982	447	6,920				7,367
Dividend Reinvestment Plan	25,915	26	658				684
Tax benefit from stock options exercised			1,448				1,448
Cash dividends paid					(18,761)		<u>(18,761)</u>
Balance at December 31, 2002	<u>30,917,575</u>	<u>\$30,918</u>	<u>\$149,091</u>	<u>\$ 49,086</u>	<u>\$418,582</u>	<u>\$(15,565)</u>	<u>\$632,112</u>

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended December 31,		
	2002	2001	2000
Cash flows from operating activities:			
Net income	\$ 46,255	\$ 43,493	\$ 48,692
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Change in receivables, unearned premiums, prepaid reinsurance and due to affiliate	2,867	(16,621)	(2,475)
Increase (decrease) in unpaid losses and loss settlement expenses	49,279	14,213	(36,509)
Deferred income taxes	1,055	(3,425)	(1,397)
Increase in deferred policy acquisition costs	(8,820)	(1,317)	(1,218)
Amortization and depreciation	3,116	2,854	3,215
Realized investment (gains) losses	18,448	3,071	(9,780)
Other, net	967	3,520	(3,710)
Net cash provided (used) by operating activities	<u>113,167</u>	<u>45,788</u>	<u>(3,182)</u>
Cash flows from investing activities:			
Held to maturity investments:			
Purchases	(1,038)		(3,895)
Maturities	55,547	42,329	37,725
Available for sale investments:			
Purchases	(260,262)	(303,610)	(142,691)
Maturities	56,950	75,662	58,240
Sales	103,322	165,796	37,070
Net (purchases) sales or maturities of short-term investments	(52,997)	(12,814)	35,342
Purchases of property and equipment	(2,439)	(3,724)	(3,612)
Net cash provided (used) by investing activities	<u>(100,917)</u>	<u>(36,361)</u>	<u>18,179</u>
Cash flows from financing activities:			
Issuance of common stock	8,051	7,807	6,419
Repayment of debt	(435)	(395)	(360)
Dividends paid	(18,761)	(17,002)	(15,864)
Purchase of treasury stock			(4,711)
Net cash used by financing activities	<u>(11,145)</u>	<u>(9,590)</u>	<u>(14,516)</u>
Increase (decrease) in cash	1,105	(163)	481
Cash at beginning of year	<u>1,839</u>	<u>2,002</u>	<u>1,521</u>
Cash at end of year	<u>\$ 2,944</u>	<u>\$ 1,839</u>	<u>\$ 2,002</u>

See accompanying notes to consolidated financial statements.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****1 - Description of Business and Summary of Significant Accounting Policies****Description of Business**

Harleysville Group consists of Harleysville Group Inc. and its subsidiaries (all wholly owned). Those subsidiaries are:

- Harleysville-Atlantic Insurance Company (Atlantic)
- Harleysville Insurance Company (HIC)
- Harleysville Insurance Company of New Jersey (HNJ)
- Harleysville Insurance Company of New York (HIC New York)
- Harleysville Insurance Company of Ohio (HIC Ohio)
- Harleysville Lake States Insurance Company (Lake States)
- Harleysville Preferred Insurance Company (Preferred)
- Harleysville Worcester Insurance Company (Worcester)
- Mid-America Insurance Company (Mid-America)
- Harleysville Ltd., a real estate partnership that owns the home office

Harleysville Group is approximately 56% owned by Harleysville Mutual Insurance Company (Mutual).

Harleysville Group underwrites property and casualty insurance in both the personal and commercial lines of insurance. The personal lines of insurance include both auto and homeowners, and the commercial lines include auto, commercial multi-peril and workers compensation. The business is marketed primarily in the eastern and midwestern United States through independent agents.

Principles of Consolidation and Basis of Presentation

The accompanying financial statements include the accounts of Harleysville Group prepared in conformity with accounting principles generally accepted in the United States of America, which differ in some respects from those followed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, including loss and loss settlement expenses, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses, including the determination of other-than-temporary declines in investments, during the reporting period. Actual results could differ from these estimates.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
(Continued)**1 - Description of Business and Summary of Significant Accounting Policies (Continued)****Investments**

Accounting for fixed maturities depends on their classification as held to maturity, available for sale or trading. Fixed maturities classified as held to maturity are carried at amortized cost. Fixed maturities classified as available for sale are carried at fair value. There were no investments classified as trading. Equity securities are carried at fair value. Short-term investments are recorded at cost, which approximates fair value.

Realized gains and losses on sales of investments are recognized in net income on the specific identification basis. A decline in the fair value of an investment below its cost that is deemed other than temporary is charged to earnings. 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.

Premiums

Premiums are recognized as revenue ratably over the terms of the respective policies. Unearned premiums are calculated on a pro rata basis.

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.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

1 - Description of Business and Summary of Significant Accounting Policies (Continued)

Losses and Loss Settlement Expenses

The liability for losses and loss settlement expenses represents estimates of the ultimate unpaid cost of all losses incurred, which includes the gross liabilities to Harleysville Group's policyholders plus the net liability to Mutual under the pooling agreement. See Note 2(a). Such estimates may be more or less than the amounts ultimately paid when the claims are settled. These estimates are periodically reviewed and adjusted as necessary; such adjustments are reflected in current operations.

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 to all periods presented.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands, except per share data)		
Net income, as reported	\$46,255	\$43,493	\$48,692
Plus: Stock-based employee compensation expense included in reported net income, net of related tax effects	2,631	687	1,258
Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(5,212)</u>	<u>(3,185)</u>	<u>(3,103)</u>
Pro forma net income	<u>\$43,674</u>	<u>\$40,995</u>	<u>\$46,847</u>
Basic earnings per share:			
As reported	\$ 1.56	\$ 1.49	\$ 1.69
Pro forma	\$ 1.47	\$ 1.40	\$ 1.62
Diluted earnings per share:			
As reported	\$ 1.53	\$ 1.46	\$ 1.67
Pro forma	\$ 1.44	\$ 1.38	\$ 1.61

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

Property and Equipment

Property and equipment are carried at cost less accumulated depreciation. Depreciation is calculated primarily on the straight-line basis over the estimated useful lives of the assets (40 years for buildings and three to 15 years for equipment).

Income Taxes

Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

Earnings Per Share

Basic earnings per share is computed by dividing earnings by the weighted-average number of common shares outstanding during the year. Diluted earnings per share includes the dilutive effect of the stock incentive plans described in Note 12.

2 - Transactions with Affiliates**(a) Underwriting**

The insurance subsidiaries participate in a reinsurance pooling agreement with Mutual whereby such subsidiaries cede to Mutual all of their insurance business and assume from Mutual an amount equal to their participation in the pooling agreement. All losses and loss settlement expenses and other underwriting expenses are prorated among the parties on the basis of participation in the pooling agreement. The agreement pertains to all insurance business written or earned on or after January 1, 1986. Harleysville Group's participation was 72% for 2002, 2001 and 2000.

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 reinsurance pooling agreement provides for the right of offset, and the net pooling balance with Mutual is not material at December 31, 2002 and 2001. Mutual has an A. M. Best rating of "A" (Excellent).

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
(Continued)**2 - Transactions with Affiliates (Continued)****(a) Underwriting (Continued)**

The following amounts represent reinsurance transactions between Harleysville Group and Mutual under the pooling arrangement:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Ceded:			
Premiums written	<u>\$689,597</u>	<u>\$649,974</u>	<u>\$606,766</u>
Premiums earned	<u>\$664,576</u>	<u>\$633,298</u>	<u>\$603,650</u>
Losses incurred	<u>\$451,105</u>	<u>\$459,906</u>	<u>\$440,973</u>
Assumed:			
Premiums written	<u>\$805,641</u>	<u>\$754,621</u>	<u>\$708,289</u>
Premiums earned	<u>\$772,426</u>	<u>\$736,924</u>	<u>\$695,147</u>
Losses incurred	<u>\$521,948</u>	<u>\$527,773</u>	<u>\$497,198</u>
Net assumed from Mutual:			
Unearned premiums	<u>\$ 54,035</u>	<u>\$ 45,841</u>	<u>\$ 44,820</u>
Unpaid losses and loss settlement expenses	<u>\$166,188</u>	<u>\$155,301</u>	<u>\$145,578</u>

Harleysville Group and Mutual are parties to a reinsurance agreement whereby Mutual, in return for a reinsurance premium, reinsured accumulated catastrophe losses in a quarter up to \$14,400,000 for 2002, 2001 and 2000. This reinsurance coverage was in excess of a retention of \$3,600,000 for 2002, 2001 and 2000. The agreement excludes catastrophe losses resulting from earthquakes, terrorism or hurricanes and supplements the existing external catastrophe reinsurance program. Under this agreement, Harleysville Group ceded to Mutual premiums earned of \$7,791,000, \$7,035,000 and \$6,817,000, and losses incurred of \$334,000, \$7,951,000 and \$4,397,000 for 2002, 2001 and 2000, respectively.

(b) Property

Harleysville Ltd. leases the home office to Mutual, which shares the facility with Harleysville Group. Rental income under the lease was \$3,531,000, \$3,512,000 and \$3,421,000 for 2002, 2001 and 2000, respectively, and is included in other income after elimination of intercompany amounts of \$2,161,000, \$2,149,000 and \$2,094,000 in 2002, 2001 and 2000, respectively.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
(Continued)**2 - Transactions with Affiliates (Continued)****(c) Management Agreements**

Harleysville Group Inc. received \$6,808,000, \$7,316,000 and \$7,425,000 of management fee income in 2002, 2001 and 2000, respectively, under agreements whereby Harleysville Group Inc. provides management services to Mutual and other affiliates. Such amounts are included in other income.

(d) Intercompany Balances

Intercompany balances are created primarily from the pooling arrangement (settled quarterly), allocation of common expenses, collection of premium balances and payment of claims (settled monthly). No interest is charged or received on intercompany balances due to the timely settlement terms and nature of the items. Interest expense on the loan from Mutual described in Note 8 was \$483,000, \$936,000 and \$1,302,000 in 2002, 2001 and 2000, respectively.

Harleysville Group has off-balance-sheet credit risk related to approximately \$68,000,000 and \$64,000,000 of premium balances due to Mutual from agents and insureds at December 31, 2002 and 2001, respectively.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

3 - Investments

The amortized cost and estimated fair value of investments, including amounts on loan under the securities lending agreement, in fixed maturity and equity securities are as follows:

	December 31, 2002			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(in thousands)			
Held to maturity:				
U.S. Treasury securities and obligations of U.S. government corpora- tions and agencies	\$ 5,324	\$ 354	\$	\$ 5,678
Obligations of states and political subdivisions	228,438	16,878		245,316
Corporate securities	<u>151,400</u>	<u>14,554</u>	<u>(6)</u>	<u>165,948</u>
Total held to maturity	<u>385,162</u>	<u>31,786</u>	<u>(6)</u>	<u>416,942</u>
Available for sale:				
U.S. Treasury securities and obligations of U.S. government corpora- tions and agencies	62,965	7,189	(33)	70,121
Obligations of states and political subdivisions	446,115	29,261	(256)	475,120
Corporate securities	328,347	26,932	(4,018)	351,261
Mortgage-backed securities	<u>214,453</u>	<u>14,063</u>	<u>(149)</u>	<u>228,367</u>
Total available for sale	<u>1,051,880</u>	<u>77,445</u>	<u>(4,456)</u>	<u>1,124,869</u>
Total fixed maturities	<u>\$1,437,042</u>	<u>\$109,231</u>	<u>\$(4,462)</u>	<u>\$1,541,811</u>
Total equity securities	<u>\$ 96,849</u>	<u>\$ 20,199</u>	<u>\$(9,871)</u>	<u>\$ 107,177</u>

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

3 - Investments (Continued)

	<u>December 31, 2001</u>			<u>Estimated Fair Value</u>
	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	
	(in thousands)			
Held to maturity:				
U.S. Treasury securities and obligations of U.S. government corpora- tions and agencies	\$ 6,407	\$ 320	\$ (48)	\$ 6,679
Obligations of states and political subdivisions	257,833	11,153	(19)	268,967
Corporate securities	<u>175,259</u>	<u>8,826</u>	<u>(143)</u>	<u>183,942</u>
Total held to maturity	<u>439,499</u>	<u>20,299</u>	<u>(210)</u>	<u>459,588</u>
Available for sale:				
U.S. Treasury securities and obligations of U.S. government corpora- tions and agencies	63,546	3,256	(156)	66,646
Obligations of states and political subdivisions	353,826	12,540	(794)	365,572
Corporate securities	374,232	12,751	(3,106)	383,877
Mortgage-backed securities	<u>164,443</u>	<u>5,121</u>	<u>(1,395)</u>	<u>168,169</u>
Total available for sale	<u>956,047</u>	<u>33,668</u>	<u>(5,451)</u>	<u>984,264</u>
Total fixed maturities	<u>\$1,395,546</u>	<u>\$53,967</u>	<u>\$(5,661)</u>	<u>\$1,443,852</u>
Total equity securities	<u>\$ 110,803</u>	<u>\$47,968</u>	<u>\$(8,085)</u>	<u>\$ 150,686</u>

The amortized cost and estimated fair value of fixed maturity securities at December 31, 2002 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

3 - Investments (Continued)

	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
	(in thousands)	
Held to maturity:		
Due in one year or less	\$ 56,446	\$ 57,432
Due after one year through five years	189,633	205,841
Due after five years through ten years	128,086	141,707
Due after ten years	<u>10,997</u>	<u>11,962</u>
	<u>385,162</u>	<u>416,942</u>
Available for sale:		
Due in one year or less	66,963	68,243
Due after one year through five years	227,052	245,800
Due after five years through ten years	442,297	473,614
Due after ten years	<u>101,115</u>	<u>108,845</u>
	837,427	896,502
Mortgage-backed securities	<u>214,453</u>	<u>228,367</u>
	<u>1,051,880</u>	<u>1,124,869</u>
Total fixed maturities	<u>\$1,437,042</u>	<u>\$1,541,811</u>

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2002 and 2001 amounted to \$25,555,000 and \$25,261,000, respectively.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

3 - Investments (Continued)

A summary of net investment income is as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Interest on fixed maturities	\$84,438	\$83,191	\$83,958
Dividends on equity securities	1,787	1,768	2,007
Interest on short-term investments	<u>1,078</u>	<u>1,712</u>	<u>1,846</u>
Total investment income	87,303	86,671	87,811
Investment expense	<u>1,038</u>	<u>1,153</u>	<u>1,020</u>
Net investment income	<u>\$86,265</u>	<u>\$85,518</u>	<u>\$86,791</u>

Realized gross gains (losses) from investments and the change in difference between fair value and cost of investments, before applicable income taxes, are as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Fixed maturity securities:			
Held to maturity:			
Gross gains	\$ 410	\$ 183	\$ 48
Gross losses	(226)	(1)	(988)
Available for sale:			
Gross gains	2,944	5,717	52
Gross losses	(2,470)	(1,394)	(916)
Equity securities:			
Gross gains	9,479	11,217	15,898
Gross losses	<u>(28,585)</u>	<u>(18,793)</u>	<u>(4,314)</u>
Net realized investment gains (losses)	<u>\$ (18,448)</u>	<u>\$ (3,071)</u>	<u>\$ 9,780</u>
Change in difference between fair value and cost of investments ⁽¹⁾ :			
Fixed maturity securities	\$ 56,463	\$ 14,310	\$ 46,321
Equity securities	<u>(29,555)</u>	<u>(28,350)</u>	<u>(23,739)</u>
Total	<u>\$ 26,908</u>	<u>\$ (14,040)</u>	<u>\$ 22,582</u>

⁽¹⁾ Parentheses indicate a net unrealized decline in fair value.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

3 - Investments (Continued)

Income taxes (benefit) on realized investment gains (losses) were \$(6,441,000), \$(1,075,000) and \$3,423,000 for 2002, 2001 and 2000, respectively.

Deferred income taxes applicable to net unrealized investment gains included in shareholders' equity were \$29,161,000 and \$23,835,000 at December 31, 2002 and 2001, respectively.

At December 31, 2002, Harleysville Group held cash collateral of \$139,215,000 related to securities on loan with a market value of \$135,544,000. 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 GICs and Funding Agreements from issuers rated "A" or better.

Under provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, an amendment of SFAS No. 133," fixed maturity investments classified as held to maturity with an amortized cost of \$81,021,000 and unrealized gains of \$1,547,000 were transferred to the available for sale classification on January 1, 2001.

Harleysville Group has not held or issued derivative financial instruments.

4 - Reinsurance

In the ordinary course of business, Harleysville Group cedes insurance to, and assumes insurance from, insurers to limit its maximum loss exposure through diversification of its risks. See Note 2(a) for discussion of reinsurance with Mutual. Reinsurance contracts do not relieve Harleysville Group of primary liability as the originating insurer. After excluding reinsurance transactions with Mutual under the pooling arrangement, the effect of Harleysville Group's share of other reinsurance on premiums written and earned is as follows:

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
(Continued)**4 - Reinsurance (Continued)**

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Premiums written:			
Direct	\$842,897	\$781,190	\$740,425
Assumed	22,189	29,683	26,415
Ceded	<u>(67,236)</u>	<u>(63,286)</u>	<u>(65,368)</u>
Net premiums written	<u>\$797,850</u>	<u>\$747,587</u>	<u>\$701,472</u>
Premiums earned:			
Direct	\$807,332	\$761,792	\$738,797
Assumed	25,215	29,442	25,653
Ceded	<u>(67,911)</u>	<u>(61,345)</u>	<u>(76,120)</u>
Net premiums earned	<u>\$764,636</u>	<u>\$729,889</u>	<u>\$688,330</u>

Losses and loss settlement expenses are net of reinsurance recoveries of \$38,172,000, \$68,852,000 and \$55,638,000 for 2002, 2001 and 2000, respectively.

5 - Contingency

GE Reinsurance Corporation (GE Re) had sought rescission 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.

On December 13, 2002, Mutual and GE Re settled this matter by agreeing to a commutation and termination of the reinsurance agreement effective December 31, 2002. The settlement agreement did not materially impact Harleysville Group's financial statements.

6 - Property and Equipment

Property and equipment consisted of land and buildings with a cost of \$30,511,000 and \$29,867,000, and equipment, including software, with a cost of \$15,569,000 and \$14,782,000 at December 31, 2002 and 2001, respectively. Accumulated depreciation related to such assets was \$18,524,000 and \$15,776,000 at December 31, 2002 and 2001, respectively.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

6 - Property and Equipment (Continued)

Rental expense under leases with non-affiliates amounted to \$1,960,000, \$2,832,000 and \$3,519,000 for 2002, 2001 and 2000, respectively. Operating lease commitments were not material at December 31, 2002.

7 - Liability for Unpaid Losses and Loss Settlement Expenses

Activity in the liability for unpaid losses and loss settlement expenses is summarized as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Liability at January 1	\$879,056	\$864,843	\$901,352
Less reinsurance recoverables	<u>78,195</u>	<u>72,259</u>	<u>77,438</u>
Net liability at January 1	<u>800,861</u>	<u>792,584</u>	<u>823,914</u>
Incurred related to:			
Current year	526,265	537,172	541,738
Prior years	<u>(4,648)</u>	<u>(17,350)</u>	<u>(48,937)</u>
Total incurred	<u>521,617</u>	<u>519,822</u>	<u>492,801</u>
Paid related to:			
Current year	199,874	229,435	244,978
Prior years	<u>265,422</u>	<u>282,110</u>	<u>279,153</u>
Total paid	<u>465,296</u>	<u>511,545</u>	<u>524,131</u>
Net liability at December 31	857,182	800,861	792,584
Plus reinsurance recoverables	<u>71,153</u>	<u>78,195</u>	<u>72,259</u>
Liability at December 31	<u>\$928,335</u>	<u>\$879,056</u>	<u>\$864,843</u>

Harleysville Group recognized favorable development in the provision for insured events of prior years of \$4,648,000, \$17,350,000 and \$48,937,000 in 2002, 2001 and 2000, respectively. The favorable development for 2002 primarily relates to lower-than-expected claim severity in the commercial and personal lines of business. The favorable development for 2001 primarily relates to lower-than-expected loss settlement expenses and, for 2000, lower-than-expected loss settlement expenses and lower-than-expected claim severity in the commercial and personal lines of business. The 2001 and 2000 favorable development includes

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
(Continued)**7 - Liability for Unpaid Losses and Loss Settlement Expenses**
(Continued)

\$14,772,000 and \$20,186,000 of reductions in loss settlement expenses. In both years, such reductions are related to benefits from initiatives to reduce costs of adjusting claims and to the favorable development on losses.

In establishing the liability for unpaid losses and loss settlement expenses, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known losses (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted losses. Estimates of the liabilities are reviewed and updated continually.

The property and casualty insurance industry has received significant publicity about environmental-related losses from exposures insured many years ago. Since the intercompany pooling agreement pertains to insurance business written or earned on or after January 1, 1986, Harleysville Group has not incurred significant environmental-related losses.

8 - Debt

Debt is as follows:

	December 31,	
	2002	2001
	(in thousands)	
Notes, 6.75%, due 2003	\$75,000	\$75,000
Demand term-loan payable to Mutual, LIBOR plus 0.65%, due 2005	18,500	18,500
Economic Development Corporation (EDC) Revenue Bond obligation	<u>2,120</u>	<u>2,555</u>
Total debt	<u>\$95,620</u>	<u>\$96,055</u>

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

8 - Debt (Continued)

The fair value of the notes was \$76,069,000 and \$76,388,000 at December 31, 2002 and 2001, respectively, based on quoted market prices for the same or similar debt. The carrying value of the remaining debt approximates fair value.

The EDC obligation is secured by Lake States' building. Interest is payable semiannually at a variable rate (1.7% at December 31, 2002) equal to the market interest rate that would allow the bonds to be remarketed at par value. The bonds are subject to redemption prior to maturity in 2006 at levels dependent upon the occurrence of certain events.

Interest paid was \$5,599,000, \$6,134,000 and \$6,507,000 in 2002, 2001 and 2000, respectively.

9 - Restructuring Charges

In 1999 and 2000, Harleysville Group recorded restructuring charges in connection with the consolidation of its claims offices and field operations. There is no remaining liability for these restructurings at December 31, 2002. The charge (benefit) to earnings for these restructuring charges was \$15,000, \$(118,000) and \$949,000 for 2002, 2001 and 2000, respectively. The 2002 and 2001 amounts primarily are from changes in the estimate of occupancy costs.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

10 - Shareholders' Equity

Comprehensive income consisted of the following:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Net income	<u>\$46,255</u>	<u>\$ 43,493</u>	<u>\$48,692</u>
Other comprehensive income:			
Unrealized investment holding gains (losses) arising during period, net of taxes (benefits) of \$(1,195), \$(7,463) and \$6,082	(2,220)	(13,859)	11,296
Less:			
Reclassification adjustment for (gains) losses included in net income, net of taxes (benefits) of \$(6,521), \$(1,139) and \$3,752	<u>12,111</u>	<u>2,114</u>	<u>(6,968)</u>
Net unrealized investment gains (losses)	<u>9,891</u>	<u>(11,745)</u>	<u>4,328</u>
Minimum pension liability net of taxes (benefits) of \$(2,730)	<u>(5,070)</u>		
Other comprehensive income	<u>4,821</u>	<u>(11,745)</u>	<u>4,328</u>
Comprehensive income	<u>\$51,076</u>	<u>\$ 31,748</u>	<u>\$53,020</u>

A source of cash for the payment of dividends is dividends from subsidiaries. Harleysville Group Inc.'s insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis, and are subject to risk-based capital requirements and to regulations under which payment of a dividend from statutory surplus is restricted and may require prior approval of regulatory authorities. Applying the current regulatory restrictions as of December 31, 2002, \$10,960,000 would be available for distribution to Harleysville Group Inc. without prior approval until October 1, 2003, after which \$52,860,000 would be available for distribution to Harleysville Group Inc. without prior approval.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
(Continued)**10 - Shareholders' Equity (Continued)**

The National Association of Insurance Commissioners (NAIC) has adopted the Codification of Statutory Accounting Principles, which were effective January 1, 2001. The codified principles are intended to provide a basis of accounting recognized and adhered to in the absence of, conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the January 1, 2001 statutory capital and surplus of the Company's insurance subsidiaries ranged from a decrease of \$442,000 to an increase of \$6,397,000 and was an increase of \$21,003,000 on a consolidated basis.

The following table contains selected information for Harleysville Group Inc.'s property and casualty insurance subsidiaries, as determined in accordance with prescribed statutory accounting practices:

	<u>December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Statutory capital and surplus	<u>\$509,344</u>	<u>\$538,878</u>	<u>\$515,679</u>
Statutory unassigned surplus	<u>\$375,075</u>	<u>\$404,609</u>	<u>\$381,410</u>
Statutory net income	<u>\$ 42,338</u>	<u>\$ 41,095</u>	<u>\$ 48,412</u>

11 - Income Taxes

The components of income tax expense (benefit) are as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Current	\$ 9,172	\$11,732	\$10,410
Deferred	<u>1,055</u>	<u>(3,425)</u>	<u>(1,397)</u>
	<u>\$10,227</u>	<u>\$ 8,307</u>	<u>\$ 9,013</u>

Cash paid for federal income taxes in 2002, 2001 and 2000 was \$13,250,000, \$13,158,000 and \$6,499,000, respectively.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

11 - Income Taxes (Continued)

The actual income tax rate differed from the statutory federal income tax rate applicable to income before income taxes as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Statutory federal income tax rate	35.0%	35.0%	35.0%
Tax-exempt interest	(16.8)	(19.3)	(19.7)
Other, net	<u>(0.1)</u>	<u>0.3</u>	<u>0.3</u>
	<u>18.1%</u>	<u>16.0%</u>	<u>15.6%</u>

The tax effects of the significant temporary differences that give rise to deferred tax liabilities and assets are as follows:

	<u>December 31,</u>	
	<u>2002</u>	<u>2001</u>
	(in thousands)	
Deferred tax liabilities:		
Deferred policy acquisition costs	\$33,214	\$30,127
Unrealized investment gains	29,161	23,835
Other	<u>9,373</u>	<u>6,169</u>
Total deferred tax liabilities	<u>71,748</u>	<u>60,131</u>
Deferred tax assets:		
Unearned premiums	27,080	24,755
Losses incurred	42,494	41,811
Pension plan	8,077	4,842
AMT credit carryforward	6,141	4,811
Other	<u>13,740</u>	<u>13,347</u>
Total deferred tax assets	<u>97,532</u>	<u>89,566</u>
Net deferred tax asset	<u>\$25,784</u>	<u>\$29,435</u>

A valuation allowance is required to be established for any portion of the deferred tax asset that management believes will not be realized. In the opinion of management, it is more likely than not that the benefit of the deferred tax asset will be realized and, therefore, no such valuation allowance has been established.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

12 - Incentive PlansFixed Stock Option Plans

Harleysville Group has an Equity Incentive Plan (EIP) for key employees. Awards may be made in the form of stock options, stock appreciation rights (SARs), restricted stock or any combination of the above. The EIP was amended in 1997 and limited future awards to an aggregate of 4,260,946 shares of Harleysville Group Inc.'s common stock. The plan provides that stock options may become exercisable from six months to 10 years from the date of grant with an option price not less than fair market value on the date of grant. The options normally vest 50% at the end of one year and 50% at the end of two years from the date of grant. SARs have not been material.

The income tax benefit related to the difference between the market price at the date of exercise and the option price for non-qualified stock options was credited to additional paid-in capital.

The Harleysville Group Inc. Year 2000 Directors' Stock Option Program provides for the granting of options to eligible directors to purchase a maximum of 123,500 shares of common stock. Options are granted at exercise prices equal to fair market value on the date of grant. The options vest immediately, although no option is exercisable until six months after the date of grant. The options have a term of 10 years.

Harleysville Group maintains stock option plans for substantially all employees and certain designated agents. The plans provide for the granting of options to purchase a maximum of 850,000 shares of common stock. The plans provide that the options become exercisable from three to 10 years from the date of grant with an option price not less than fair market value on the date of grant.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

12 - Incentive Plans (continued)

Information regarding activity in Harleysville Group's fixed stock option plans is presented below:

	<u>Number of Shares</u>	<u>Weighted-Average Exercise Price Per Share</u>
Outstanding at December 31, 1999	2,115,944	\$16.30
Granted--2000	434,361	16.48
Exercised--2000	(254,567)	12.65
Forfeited--2000	<u>(187,948)</u>	<u>18.09</u>
Outstanding at December 31, 2000	2,107,790	16.62
Granted--2001	475,850	26.36
Exercised--2001	(259,912)	14.26
Forfeited--2001	<u>(84,180)</u>	<u>16.31</u>
Outstanding at December 31, 2001	2,239,548	18.97
Granted--2002	495,917	27.20
Exercised--2002	(323,611)	14.98
Forfeited--2002	<u>(291,313)</u>	<u>15.93</u>
Outstanding at December 31, 2002	<u>2,120,541</u>	<u>\$21.92</u>
Exercisable at:		
December 31, 2000	<u>1,552,506</u>	<u>\$16.37</u>
December 31, 2001	<u>1,608,426</u>	<u>\$17.21</u>
December 31, 2002	<u>1,455,606</u>	<u>\$19.64</u>

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

12 - Incentive Plans (continued)

The following table summarizes information about fixed stock options at December 31, 2002:

	<u>Range of Exercise Prices</u>		
	<u>\$11.13-16.69</u>	<u>\$17.94-24.50</u>	<u>\$26.36-27.20</u>
Options outstanding at December 31, 2002:			
Number of options	<u>546,240</u>	<u>664,556</u>	<u>909,745</u>
Weighted-average remaining contractual life	<u>5.3 years</u>	<u>5.5 years</u>	<u>8.9 years</u>
Weighted-average exercise price	<u>\$14.76</u>	<u>\$21.12</u>	<u>\$26.81</u>
Options exercisable at December 31, 2002:			
Number of options	<u>546,240</u>	<u>662,556</u>	<u>246,810</u>
Weighted-average exercise price	<u>\$14.76</u>	<u>\$21.13</u>	<u>\$26.45</u>

The per share weighted-average fair value of options granted during 2002, 2001 and 2000 was \$9.04, \$8.45 and \$4.80, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2002, 2001 and 2000, respectively: dividend yield of 2.21%, 2.12% and 3.31%; expected volatility of 37.34%, 34.89% and 31.84%; risk-free interest rate of 4.60%, 4.77% and 6.76%; and an expected life of 5.25 years.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

12 - Incentive Plans (continued)Other Stock Purchase and Incentive Plans

Harleysville Group Inc. is authorized to issue up to 1,000,000 shares of common stock under the terms of the 1995 Employee Stock Purchase Plan. Virtually all employees are eligible to participate in the plan, under which a participant may elect to have up to 15% of base pay withheld to purchase shares. The purchase price of the stock is 85% of the lower of the beginning-of-the-subscription-period or end-of-the-subscription-period fair market value. Each subscription period runs from January 15 through July 14, or July 15 through January 14. Under the plan, Harleysville Group Inc. issued 92,175, 93,637 and 156,958 shares to employees in 2002, 2001 and 2000, respectively.

Under Harleysville Group Inc.'s 1995 Agency Stock Purchase Plan, eligible independent insurance agencies may invest up to \$12,500 in shares of common stock at 90% of the fair market value at the end of each six-month subscription period. There are 1,000,000 shares of common stock available under the plan. There were 43,174, 29,980 and 60,844 shares issued under the plan for which \$76,000, \$180,000 and \$66,000 of expense was recognized in 2002, 2001 and 2000, respectively.

The 1996 Directors' Stock Purchase Plan provides for the issuance of up to 200,000 shares of Harleysville Group Inc. common stock to outside directors of Harleysville Group Inc. and Mutual. The purchase price of the stock is 85% of the lower of the beginning-of-the-subscription-period or end-of-the-subscription-period fair market value. In 2002, 2001 and 2000 respectively, there were 9,647, 7,999 and 4,965 shares issued under the plan for which \$31,000, \$75,000 and \$20,000 of expense was recognized.

Harleysville Group has incentive bonus plans. Cash and common stock bonuses are earned on a formula basis depending upon the performance of Harleysville Group and Mutual in relation to certain targets. There are 600,000 shares of common stock available under the Long Term Incentive Plan and none of these shares has been issued. Harleysville Group's expense for such plans was \$7,291,000, \$1,808,000 and \$2,963,000 for 2002, 2001 and 2000, respectively.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

13 - Pension and Other Benefit Plans

Harleysville Group Inc. has a pension plan that covers substantially all full-time employees. Retirement benefits are a function of both the years of service and level of compensation. Harleysville Group Inc.'s funding policy is to contribute annually an amount equal to at least the minimum required contribution in accordance with minimum funding standards established by ERISA. Contributions are intended to provide not only for benefits attributed to service to date, but also for those expected to be earned in the future.

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

13 - Pension and Other Benefit Plans (continued)

The following table sets forth the year-end status of the plan including Mutual:

	<u>2002</u>	<u>2001</u>
	(in thousands)	
Change in benefit obligation		
Benefit obligation at January 1	\$126,900	\$110,066
Service cost	5,632	4,745
Interest cost	9,137	8,348
Amendments	28	
Net actuarial loss	12,780	8,035
Benefits paid	<u>(4,645)</u>	<u>(4,294)</u>
Benefit obligation at December 31	<u>\$149,832</u>	<u>\$126,900</u>
Change in plan assets		
Fair value of plan assets at January 1	\$101,967	\$118,727
Actual return on plan assets	(17,549)	(12,657)
Contributions	2,493	
Benefits paid	<u>(4,448)</u>	<u>(4,103)</u>
Fair value of plan assets at December 31	<u>\$ 82,463</u>	<u>\$101,967</u>
Funded status	\$(67,369)	\$(24,933)
Unrecognized net actuarial loss (gain)	39,559	(845)
Unrecognized prior service cost	1,229	1,608
Unrecognized transition obligation	<u>213</u>	<u>266</u>
Accrued pension cost:		
Entire plan	<u>\$(26,368)</u>	<u>\$(23,904)</u>
Harleysville Group portion	<u>\$(18,159)</u>	<u>\$(16,364)</u>
Amounts recognized in the statement of financial position consist of:		
Accrued pension cost	\$(26,780)	\$(16,608)
Intangible asset	821	244
Accumulated other comprehensive income	<u>7,800</u>	<u> </u>
Net amount recognized	<u>\$(18,159)</u>	<u>\$(16,364)</u>

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

13 - Pension and Other Benefit Plans (Continued)

The net periodic pension cost for the plan including Mutual consists of the following components:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Components of net periodic pension cost:			
Service cost	\$ 5,632	\$ 4,745	\$ 4,434
Interest cost	9,137	8,348	7,482
Expected return on plan assets	(10,076)	(9,596)	(8,580)
Recognized net actuarial loss (gain)	1	(152)	(478)
Amortization of prior service cost	407	588	610
Net transition amortization	53	19	(117)
Curtailment			(1,962)
Net periodic pension cost:			
Entire plan	<u>\$ 5,154</u>	<u>\$ 3,952</u>	<u>\$ 1,389</u>
Harleysville Group portion	<u>\$ 3,477</u>	<u>\$ 2,663</u>	<u>\$ 788</u>
	<u>2002</u>	<u>2001</u>	<u>2000</u>
Weighted-average assumptions as of December 31:			
Discount rate	6.75%	7.25%	7.50%
Expected long-term rate of return on plan assets	9.00%	9.50%	9.50%
Rate of compensation increase	4.50%	4.50%	4.50%

Harleysville Group has profit-sharing plans covering qualified employees. Harleysville Group's expense under the plans was \$1,573,000, \$1,601,000 and \$2,821,000 for 2002, 2001 and 2000, respectively.

HARLEYSVILLE GROUP**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

14 - Segment Information

As an underwriter of property and casualty insurance, Harleysville Group has three reportable segments, which consist of the investment function, the personal lines of insurance and the commercial lines of insurance. Using independent agents, Harleysville Group markets personal lines of insurance to individuals, and commercial lines of insurance to small and medium-sized businesses.

Harleysville Group evaluates the performance of the personal lines and commercial lines primarily based upon underwriting results as determined under statutory accounting practices (SAP). Assets are not allocated to the personal and commercial lines, and are reviewed in total by management for purposes of decision making. Harleysville Group operates only in the United States, and no single customer or agent provides 10 percent or more of revenues.

Financial data by segment is as follows:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Revenues:			
Premiums earned:			
Commercial lines	\$553,194	\$493,362	\$437,873
Personal lines	<u>211,442</u>	<u>236,527</u>	<u>250,457</u>
Total premiums earned	764,636	729,889	688,330
Net investment income	86,265	85,518	86,791
Realized investment gains (losses)	(18,448)	(3,071)	9,780
Other	<u>15,283</u>	<u>15,415</u>	<u>17,670</u>
Total revenues	<u>\$847,736</u>	<u>\$827,751</u>	<u>\$802,571</u>
Income before income taxes:			
Underwriting loss:			
Commercial lines	\$(11,473)	\$ (7,128)	\$(22,925)
Personal lines	<u>(13,963)</u>	<u>(29,372)</u>	<u>(23,281)</u>
SAP underwriting loss	(25,436)	(36,500)	(46,206)
GAAP adjustments	<u>8,803</u>	<u>2,017</u>	<u>3,602</u>
GAAP underwriting loss	(16,633)	(34,483)	(42,604)
Net investment income	86,265	85,518	86,791
Realized investment gains (losses)	(18,448)	(3,071)	9,780
Other	<u>5,298</u>	<u>3,836</u>	<u>3,738</u>
Income before income taxes	<u>\$ 56,482</u>	<u>\$ 51,800</u>	<u>\$ 57,705</u>

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

15 - Earnings Per Share

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

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(dollars in thousands, except per share data)		
Numerator for basic and diluted earnings per share:			
Net income	<u>\$46,255</u>	<u>\$43,493</u>	<u>\$48,692</u>
Denominator for basic earnings per share -- weighted-average shares outstanding	29,699,201	29,267,587	28,838,824
Effect of stock incentive plans	<u>596,748</u>	<u>550,942</u>	<u>297,582</u>
Denominator for diluted earnings per share	<u>30,295,949</u>	<u>29,818,529</u>	<u>29,136,406</u>
Basic earnings per share	<u>\$ 1.56</u>	<u>\$ 1.49</u>	<u>\$ 1.69</u>
Diluted earnings per share	<u>\$ 1.53</u>	<u>\$ 1.46</u>	<u>\$ 1.67</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:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(in thousands)		
Number of options	<u>491</u>	<u>284</u>	<u>566</u>

HARLEYSVILLE GROUP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Continued)

16 - Quarterly Results of Operations (Unaudited)

	2002				
	(in thousands, except per share data)				
	First	Second	Third	Fourth	Total
Revenues	\$208,210	\$192,149	\$222,287	\$225,090	\$847,736
Losses and expenses	191,287	195,353	202,562	202,052	791,254
Net income	13,340	296	15,216	17,403	46,255
Earnings per common share:					
Basic	\$.45	\$.01	\$.51	\$.58	\$ 1.56
Diluted	\$.44	\$.01	\$.50	\$.57	\$ 1.53

	2001				
	(in thousands, except per share data)				
	First	Second	Third	Fourth	Total
Revenues	\$200,320	\$203,442	\$205,821	\$218,168	\$827,751
Losses and expenses	189,523	190,309	197,396	198,723	775,951
Net income	9,718	10,978	7,855	14,942	43,493
Earnings per common share:					
Basic	\$.33	\$.38	\$.27	\$.51	\$ 1.49
Diluted	\$.33	\$.37	\$.26	\$.50	\$ 1.46

Independent Auditors' Report

The Board of Directors
and Shareholders
Harleysville Group Inc.:

We have audited the accompanying consolidated balance sheets of Harleysville Group as of December 31, 2002 and 2001, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2002. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Harleysville Group as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

/s/KPMG LLP

Philadelphia, Pennsylvania
February 14, 2003

EXHIBIT 13(E)

Market for Common Stock and Related Security Holder Matters

The stock of Harleysville Group Inc. is quoted on the Nasdaq National Market System, and assigned the symbol HGIC. At the close of business on March 5, 2003, the approximate number of holders of record of Harleysville Group Inc.'s common stock was 2,404 (counting all shares held in single nominee registration as one shareholder).

The payment of dividends is subject to the discretion of Harleysville Group Inc.'s Board of Directors which each quarter considers, among other factors, Harleysville Group's operating results, overall financial condition, capital requirements and general business conditions. The present quarterly dividend of \$0.165 per share paid in each of the third and fourth quarters of 2002 is expected to continue during 2002. As a holding company, one of Harleysville Group Inc.'s sources of cash with which to pay dividends is dividends from its subsidiaries. Harleysville Group Inc.'s insurance company subsidiaries are subject to state laws that restrict their ability to pay dividends. See Note 10 of the Notes to Consolidated Financial Statements.

The following table sets forth the amount of cash dividends declared per share, and the high and low bid quotations as reported by Nasdaq for Harleysville Group Inc.'s common stock for each quarter during the past two years.

2002	High	Low	Cash Dividends Declared
First Quarter	\$27.26	\$22.60	\$.15
Second Quarter	32.37	24.46	.15
Third Quarter	27.87	19.57	.165
Fourth Quarter	29.05	23.32	.165

2001	High	Low	Cash Dividends Declared
First Quarter	\$30.06	\$20.44	\$.14
Second Quarter	30.01	21.44	.14
Third Quarter	30.15	19.10	.15
Fourth Quarter	26.72	23.14	.15

SUBSIDIARIES OF REGISTRANT

Registrant owns 100% of the outstanding stock of each of the following corporations:

<u>Name</u>	<u>State of Incorporation</u>
Harleysville Insurance Company of Ohio	Ohio
Harleysville-Atlantic Insurance Company	Georgia
Harleysville Insurance Company of New Jersey	New Jersey
Harleysville Preferred Insurance Company	Pennsylvania
Harleysville Lake States Insurance Company	Michigan
Mid-America Insurance Company	Pennsylvania
Harleysville Insurance Company	Minnesota
Harleysville Insurance Company of New York	New York
Harleysville Worcester Insurance Company	Massachusetts

EXHIBIT (23)

INDEPENDENT AUDITORS' CONSENT AND REPORT ON SCHEDULES

The Board of Directors
Harleysville Group Inc.:

The audits referred to in our report dated February 14, 2003 included the related financial statement schedules as of December 31, 2002, and for each of the years in the three-year period ended December 31, 2002, included in the annual report on Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We consent to incorporation by reference in the registration statements (Nos. 333-03127, 33-84348, 33-91726, 33-43532, 333-85941, 333-37386, 333-37212) on Form S-8 and registration statements (Nos. 33-78372, 33-90810) on Form S-3 of Harleysville Group Inc. of our report dated February 14, 2003, relating to the consolidated balance sheets of Harleysville Group Inc. as of December 31, 2002 and 2001, and the related consolidated statements of income, shareholders' equity and cash flows and related financial statement schedules for each of the years in the three-year period ended December 31, 2002, which reports appear in the December 31, 2002 annual report on Form 10-K of Harleysville Group Inc., and of our report dated March 19, 2003 relating to the statements of financial condition of the Harleysville Group Inc. Employee Stock Purchase Plan as of December 31, 2002 and 2001, and the related statements of income and changes in plan equity for each of the years in the three-year period ended December 31, 2002, which report appears in the Harleysville Group Inc. Employee Stock Purchase Plan annual report on Form 11-K.

/s/ KPMG LLP

Philadelphia, Pennsylvania
March 19, 2003

FORM 11-K

FOR ANNUAL REPORTS OF EMPLOYEE STOCK PURCHASE, SAVINGS
AND SIMILAR PLANS PURSUANT TO SECTION 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2002

OR

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

For the transition period from _____ to _____

Commission file number 0-14697

- A. Full title of the plan and the address of the plan, if
different from that of the issuer named below:

HARLEYSVILLE GROUP INC.

EMPLOYEE STOCK PURCHASE PLAN

- B. Name of issuer of the securities held pursuant to the
plan and the address of its principal executive office:

Harleysville Group Inc.
355 Maple Avenue
Harleysville, Pennsylvania 19438-2297

HARLEYSVILLE GROUP INC.
EMPLOYEE STOCK PURCHASE PLAN
FORM 11-K
DECEMBER 31, 2002

Financial Statements

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Statements of Financial Condition as of December 31, 2002 and 2001	4
Statements of Income and Changes in Plan Equity for each of the years in the three-year period ended December 31, 2002	5
Notes to Financial Statements	6
Schedules - Schedules I, II and III have been omitted because they are not required, are not applicable, or the required information is shown in the financial statements or notes thereto.	

INDEPENDENT AUDITORS' REPORT

The Administrative Committee
Harleysville Group Inc.
Employee Stock Purchase Plan:

We have audited the accompanying statements of financial condition of Harleysville Group Inc. Employee Stock Purchase Plan as of December 31, 2002 and 2001, and the related statements of income and changes in plan equity for each of the years in the three-year period ended December 31, 2002. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of the Harleysville Group Inc. Employee Stock Purchase Plan as of December 31, 2002 and 2001, and the income and changes in its plan equity for each of the years in the three-year period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

/s/KPMG LLP

Philadelphia, Pennsylvania
March 19, 2003

HARLEYSVILLE GROUP INC.
EMPLOYEE STOCK PURCHASE PLAN
STATEMENTS OF FINANCIAL CONDITION

	As of December 31,	
	2002	2001
<u>Assets</u>		
Receivable from affiliate	<u>\$919,913</u>	<u>\$888,552</u>
 <u>Plan Equity</u>		
Net assets available for plan participants	<u>\$919,913</u>	<u>\$888,552</u>

See accompanying notes to financial statements.

**HARLEYSVILLE GROUP INC.
EMPLOYEE STOCK PURCHASE PLAN**

STATEMENTS OF INCOME AND CHANGES IN PLAN EQUITY

	Years Ended December 31,		
	2002	2001	2000
Contributions - Employees	\$ 1,892,602	\$ 1,846,292	\$ 1,751,002
Purchase and distribution of Harleystville Group Inc. stock to employees	(1,780,377)	(1,691,118)	(1,784,602)
Employee withdrawals and terminations	(80,864)	(69,688)	(95,233)
Net increase (decrease)	31,361	85,486	(128,833)
Plan equity beginning of year	888,552	803,066	931,899
Plan equity end of year	\$ 919,913	\$ 888,552	\$ 803,066

See accompanying notes to financial statements.

HARLEYSVILLE GROUP INC.
EMPLOYEE STOCK PURCHASE PLAN
NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

The accounts of the plan are maintained on the accrual basis. The receivable from affiliate represents the biweekly contributions from employees which are made in the form of regular payroll deductions and are recorded by the plan after each biweekly pay period.

2. Description of the Plan

All regular full-time employees and regular part-time employees who work at least twenty hours a week are eligible to participate in the plan.

Eligible employees must authorize a payroll deduction equal to no more than 15 percent of their base pay during the enrollment periods to participate in the plan. The enrollment periods are the 1st through 14th day of January and July of each plan year. Once enrolled, an eligible employee will continue to participate in the plan for each succeeding subscription period until the employee terminates participation or ceases to be an eligible employee.

Each subscription period will run from January 15 through July 14 or from July 15 through January 14. At the close of each pay period, the amount to be deducted from each participant's base pay will be credited to such participant's plan account. On the last day of each subscription period, the amount credited to each participant's plan account will be divided by the subscription price for that subscription period and the participant's account will be credited with the number of the whole and fractional shares which results. Participants may request such shares to be issued in certificate form.

If a participant desires to change the rate of contribution the participant may do so effective for the next subscription period by filing a new subscription agreement during the applicable enrollment period. At any time, a participant may withdraw from the plan and receive cash for the amount deducted from the participant's base pay during that subscription period by giving written notice to the Company. Separation from employment for any reason including death, disability or retirement shall be treated as an automatic withdrawal from the plan.

At December 31, 2002 there were 686 participants in the plan. Harleysville Group Inc. has borne all costs of administering the plan.

HARLEYSVILLE GROUP INC.
EMPLOYEE STOCK PURCHASE PLAN
NOTES TO FINANCIAL STATEMENTS
(Continued)

3. Investment

The contributions credited to the participant's account are used to purchase shares of Harleysville Group Inc. common stock at a specified subscription price. The subscription price for each share of common stock shall be the lesser of 85 percent of the fair market value of such shares on the last trading day before the first day of the subscription period or 85 percent of the fair market value of such share on the last day of the subscription period. The fair market value of a share shall be the closing price as reported on the NASDAQ National Market System on the applicable date. The total number of shares to be made available under the plan is 1,000,000 shares of common stock of the Company.

4. Tax Status

The plan is intended to qualify under the provisions of Section 423 of the Internal Revenue Code. No income will be realized for federal income tax purposes by a participant upon the purchase of shares under the plan. Tax consequences to the Company and to plan participants upon disposition of shares under the plan vary depending on the length of time held and fair market value at time of disposition.

5. Plan Termination

The plan will be in effect until the earlier of July 31, 2005 or the date on which plan participants have subscribed for the total number of shares available for purchase under the plan. At December 31, 2002, there are approximately 148,264 shares that remain available for issuance under the plan. During the effective duration of the plan, there will be twenty subscription periods.

6. Subsequent Events

On January 14, 2003, 46,192 shares of stock were purchased at a subscription price of \$20.87 per share on behalf of the plan participants for the subscription period ended January 14, 2003.

**HARLEYSVILLE GROUP INC.
EMPLOYEE STOCK PURCHASE PLAN**

**NOTES TO FINANCIAL STATEMENTS
(Continued)**

On February 26, 2003, the Board of Directors of Harleysville Group Inc. approved amendments to the plan under which (i) the termination date to the plan would be extended to July 31, 2008, and (ii) 650,000 additional shares would be made available under the plan. These amendments have been recommended to the stockholders of Harleysville Group Inc. for their approval at the annual meeting of stockholders to be held on April 23, 2003.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the trustees (or other persons who administer the plan) have duly caused this annual report to be signed by the undersigned hereunto duly authorized.

HARLEYSVILLE GROUP INC.**EMPLOYEE STOCK PURCHASE PLAN**Date: March 26, 2003By: /s/ BRUCE J. MAGEE
Bruce J. Magee, Member,
Administrative Committee for
Harleysville Group Inc.
Employee Stock Purchase Plan

Exhibit (99.1)

**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 Annual Report of the Harleysville Group Inc. (the "Company") on Form 10-K for the period ended December 31, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Walter R. Bateman, Chairman of the Board 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: March 26, 2003

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

Exhibit (99.2)

**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 Annual Report of the Harleysville Group Inc. (the "Company") on Form 10-K for the period ended December 31, 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: March 26, 2003

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