

DONEGAL GROUP INC
Form 11-K
June 22, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 11-K**

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

For the fiscal year ended December 31, 2006

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

For the transition period from _____ to _____

Commission file no.: 333-93785

Donegal Mutual Insurance Company 401(k) Plan
1195 River Road

Marietta, Pennsylvania 17547

(Full title of the plan and the address of the plan,
if different from that of the issuer named below)

Donegal Group Inc.

1195 River Road

Marietta, Pennsylvania 17547

(Name of issuer of the securities held
pursuant to the plan and the address
of its principal executive office)

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**DONEGAL MUTUAL INSURANCE
COMPANY 401(k) PLAN
FINANCIAL STATEMENTS WITH
SUPPLEMENTAL SCHEDULE
YEARS ENDED DECEMBER 31, 2006 AND 2005
AND
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
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Report of Independent Registered Public Accounting Firm

To the Plan Administrator

Donegal Mutual Insurance Company 401(k) Plan

We have audited the accompanying statements of net assets available for benefits of the Donegal Mutual Insurance Company 401(k) Plan as of December 31, 2006 and 2005, and the related statements of changes in net assets available for benefits for the years then ended. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion. 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 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 net assets available for benefits of the Plan as of December 31, 2006 and 2005, and the changes in net assets available for benefits for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedule of assets (held at end of year) as of December 31, 2006 is presented for the purpose of additional analysis and is not a required part of the basic financial statements but is supplemental information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. This supplemental schedule is the responsibility of the Plan's management. The supplemental schedule has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ Beard Miller Company LLP

Beard Miller Company LLP
Lancaster, Pennsylvania
June 1, 2007

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DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
STATEMENTS OF NET ASSETS AVAILABLE FOR BENEFITS
DECEMBER 31, 2006 AND 2005

	2006	2005
Assets		
Investments, at fair value		
Interest-bearing cash	\$ 3,146,865	\$ 2,907,895
Common/collective trusts	3,302,964	2,845,127
Registered investment companies	24,260,670	20,882,133
Employer securities	4,386,462	3,762,525
	35,096,961	30,397,680
Cash (non-interest bearing)	4,150	
Net assets available for benefits	\$ 35,101,111	\$ 30,397,680

The accompanying notes are an integral
part of these financial statements.

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DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
STATEMENTS OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS
YEARS ENDED DECEMBER 31, 2006 AND 2005

	2006	2005
Additions		
Investment income		
Interest	\$ 139,032	\$ 79,501
Dividends	1,574,034	1,067,995
Net realized/unrealized appreciation in fair value of investments	2,268,198	1,556,265
	3,981,264	2,703,761
Contributions		
Employer	978,847	984,691
Participants	1,752,336	1,706,036
Rollover	42	178,133
	2,731,225	2,868,860
Total additions	6,712,489	5,572,621
Deductions		
Benefits paid to participants	2,009,058	1,497,852
Net increase	4,703,431	4,074,769
Net assets available for benefits -		
Beginning of year	30,397,680	26,322,911
End of year	\$ 35,101,111	\$ 30,397,680

The accompanying notes are an integral
part of these financial statements.

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**DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
NOTES TO FINANCIAL STATEMENTS**

1. DESCRIPTION OF PLAN

The following description of the Donegal Mutual Insurance Company (the Company) 401(k) Plan (the Plan) provides only general information. Participants should refer to the Plan for a more complete description of the Plan's provisions.

General

The Plan is a defined contribution 401(k) plan, which became effective January 1, 1998. All employees of the Company are eligible to participate as of the first day of the month after the month in which their employment with the Company commences. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

Contributions

Participants may contribute between 1% and 100% of their annual compensation up to the maximum limit established by the Internal Revenue Code (IRC). Contributions made to each participant's account will be invested, based on the individual's direction, in various investment options. The Plan has additional limitations on pretax contributions for highly compensated participants. For the Plan years 2006 and 2005, a highly compensated participant, as defined by the Plan, is a participant with an annual salary equal to or greater than \$100,000 and \$95,000, respectively. The Company will contribute, on behalf of each participant, a sum equal to 100% of the first 3% of participant deferrals and 50% of the next 6%.

Participant Accounts

Each participant's account is credited with the participant's contribution and an allocation of the following in accordance with Plan provisions: (a) the Company's contribution and (b) Plan earnings. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.

Vesting

Participants are immediately vested in their salary deferral contributions and earnings thereon, as well as all amounts that transferred into the Plan during the 2000 year from the discontinued Money Purchase Pension Plan and Profit Sharing Plan. Vesting of employer matching contributions and earnings thereon is based on years of service. A participant is 100% vested after 3 years of credited service.

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**DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
NOTES TO FINANCIAL STATEMENTS**

1. DESCRIPTION OF PLAN (Cont d)

Payment of Benefits

The normal retirement date is the first of the month following attainment of age 65. Early retirement is possible at age 55. Benefits are paid in the form of a lump-sum distribution. Upon termination of service for other reasons, participants will receive a lump-sum distribution if the total of their vested balance does not exceed \$1,000. If the vested balance exceeds \$1,000, but is less than \$5,000, the participant may elect to receive a lump-sum distribution, however, if no election is made, the Plan Committee will pay the distribution in a direct rollover to an individual retirement plan designated by the Committee. If the vested balance exceeds \$5,000, the assets will generally be held in the Plan until the participant's normal or early retirement date. However, participants are entitled to receive the entire balance in their employee account and employer account (if vested) as a lump-sum distribution, as soon as administratively possible. There is a provision available to allow hardship withdrawals of benefits prior to termination of employment as defined in the Plan and in compliance with the Internal Revenue Code.

Forfeitures

Forfeitures arising from distributions to participants who are less than 100% vested will be used to restore any accounts of participants reemployed during the plan year or to reduce employer contributions per guidelines established by the Plan. Forfeitures used to reduce employer contributions totaled \$50,412 in 2006 and \$15,855 in 2005. As of December 31, 2006 and 2005, there was \$26,777 and \$50,412 of forfeitures to be used against future employer contributions, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The financial statements are prepared under the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America.

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**DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
NOTES TO FINANCIAL STATEMENTS**

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Cont d)

Use of Estimates

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 and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of changes in net assets available for benefits during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain amounts in 2005 as reported in the Statements of Changes in Net Assets Available for Benefits and Notes to Financial Statements have been reclassified to conform to the current year presentation.

Investments

Common/collective trusts are valued at the net value of participation units. All other investments are valued at quoted market prices as determined by the Plan trustee. Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits

Benefits are recorded when paid.

3. IMPACT OF NEW ACCOUNTING STANDARDS

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements. This statement defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of adopting this statement.

FASB Staff Position, FSP AAG INV 1 and SOP 94-4-1, Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the

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**DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
NOTES TO FINANCIAL STATEMENTS**

3. IMPACT OF NEW ACCOUNTING STANDARDS (Cont d)

AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans, states that investment contracts held by a defined-contribution plan are required to be reported at fair value. The Plan adopted this pronouncement in 2006. The adoption did not have any impact on the Plan's financial statements.

4. INVESTMENTS

Putnam Investments is both the trustee and custodian that holds the funds for the Plan during the 2006 and 2005 years and maintains an individual account for each participant. Contributions made on a participant's behalf under the Plan will be directly allocated to that participant's account.

Investments of the Plan are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investments and the level of uncertainty related to changes in the value of investments, it is at least reasonably possible that changes in risk in the near term would materially affect investment assets reported in the statements of net assets available for benefits and statements of changes in net assets available for benefits.

Net investment returns reflect certain fees paid by the investment funds to their affiliated investment advisors, transfer agents, and others as further described in each fund prospectus or other published documents. These fees are deducted prior to allocation of the Plan's investment earnings activity and thus are not separately identifiable as an expense.

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DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
NOTES TO FINANCIAL STATEMENTS

4. INVESTMENTS (Cont d)

The following table presents the fair values of investments that represent 5% or more of the Plan's net assets as of December 31:

	2006	2005
Interest-bearing cash - Putnam		
Money Market Fund	\$ 3,146,865	\$ 2,907,895
Common/collective trust		
Putnam S&P500 Index Fund	2,625,746	2,241,089
Registered investment companies		
PIMCO Total Return Fund	1,797,829	1,765,282
The Janus Fund	1,834,770	1,589,246
Putnam Asset Allocation - Balanced Portfolio	2,337,150	2,184,972
Putnam International Equity Fund	3,370,045	2,372,282
Putnam Equity Income Fund	3,217,390	3,027,185
Employer securities		
Donegal Group Inc. Class A common stock	3,431,150	2,885,898

During 2006 and 2005, the Plan's investments (including gains and losses on investments bought, sold and held during the year) appreciated in value by \$2,268,198 and \$1,556,265, respectively as follows:

	2006	2005
Registered investment companies	\$ 1,427,352	\$ 482,112
Common/collective trusts	387,510	108,757
Employer securities	453,336	965,396
	\$ 2,268,198	\$ 1,556,265

5. TAX STATUS

The Internal Revenue Service has determined and informed the Company by a letter dated December 12, 2001 that the Plan is designed in accordance with applicable sections of the IRC. Although the Plan has been amended since receiving the determination letter, the Company believes the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

Therefore, no provision for income taxes has been included in the Plan's financial statements.

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**DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
NOTES TO FINANCIAL STATEMENTS**

6. RELATED PARTY AND PARTY-IN-INTEREST

The Plan held 175,148 shares of Class A and 54,871 shares of Class B Donegal Group Inc. common stock with fair values of \$3,431,150 and \$955,312, respectively, as of December 31, 2006. The Plan held 124,178 shares of Class A and 41,253 shares of Class B Donegal Group Inc. common stock with fair values of \$2,885,898 and \$876,627, respectively, as of December 31, 2005. The net realized/unrealized appreciation of the fair value of Donegal Group Inc. common stock (including Class A and Class B) during 2006 and 2005 was \$453,336 and \$965,396, respectively. Dividends received from Donegal Group Inc. in 2006 and 2005 were \$70,355 and \$63,856, respectively. As of December 31, 2006 and 2005, the Class A shares of Donegal Group Inc. common stock represent more than 5% of net assets available for benefits.

Certain 2006 and 2005 Plan year investments are interest-bearing cash, common/ collective trusts, and registered investment companies managed by Putnam Investments. Putnam Investments is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest transactions. All other transactions relate to normal plan management and the related payment of fees.

7. ADMINISTRATIVE EXPENSES

Certain administrative functions are performed by officers or employees of the Plan's sponsor. No such officer or employee receives compensation from the Plan. All of the trustee fees and audit fees were paid directly by the Company in 2006 and 2005.

8. PLAN TERMINATION

Although it has not expressed an intention to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100% vested in their accounts.

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DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
SUPPLEMENTAL SCHEDULE

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Schedule H Financial Information (Form 5500)

Part IV Line 4i Schedule of Assets (Held at End of Year)
Name of Plan Sponsor: Donegal Mutual Insurance Company
Name of Plan: Donegal Mutual Insurance Company 401(k) Plan
Employer Identification Number: 23-1336198
Three-digit Plan Number: 003
December 31, 2006

(a) Identity of issue, borrower, lessor, or similar party	(b)	(c) Description of investment including maturity date, rate of interest, collateral, par, or maturity value	(d) Cost	(e) Current Value
* Putnam Money Market Fund		3,146,865 Shares of Money Market Fund	**	\$ 3,146,865
Total interest-bearing cash				3,146,865
* Putnam Bond Index Fund		45,420 Common/Collective Trust Units	**	677,218
* Putnam S&P500 Index Fund		70,642 Common/Collective Trust Units	**	2,625,746
Total common/collective trusts				3,302,964
* Putnam Capital Opportunities Fund		120,080 Mutual Fund Shares	**	1,392,931
MSIF Small Company Growth Fund		100,122 Mutual Fund Shares	**	1,264,540
PIMCO Total Return Fund		173,201 Mutual Fund Shares	**	1,797,829
The Janus Fund		65,201 Mutual Fund Shares	**	1,834,770
* The George Putnam Fund of Boston		80,420 Mutual Fund Shares	**	1,450,781
Davis New York Venture Fund		35,257 Mutual Fund Shares	**	1,358,098
American Funds Growth Fund of America		17,205 Mutual Fund Shares	**	558,297
* Putnam Asset Allocation - Growth Portfolio		112,770 Mutual Fund Shares	**	1,596,825
* Putnam Asset Allocation - Balanced Portfolio		189,090 Mutual Fund Shares	**	2,337,150
* Putnam Asset Allocation - Conservative Portfolio		59,050 Mutual Fund Shares	**	577,511
* Putnam International Equity Fund		107,566	**	3,370,045

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		Mutual Fund Shares		
*	Putnam Equity Income Fund	182,495	Mutual Fund Shares	** 3,217,390
*	Putnam Mid Cap Value Fund	67,297	Mutual Fund Shares	** 997,339
	Alger Midcap Growth Institutional Portfolio	44,513	Mutual Fund Shares	** 753,607
	Neuberger & Berman Genesis Trust	36,739	Mutual Fund Shares	** 1,753,557
	Total registered investment companies (mutual funds)			24,260,670
*	Donegal Group Inc.	175,148	Shares of Class A Common Stock	** 3,431,150
*	Donegal Group Inc.	54,871	Shares of Class B Common Stock	** 955,312
	Total employer securities			4,386,462
	Total investments			\$ 35,096,961

* Party-in-interest

** Historical cost information is not required to be disclosed for participant-directed investments.

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DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the trustees (or other persons who administer the employee benefit plan) have duly caused this annual report to be signed on its behalf by the undersigned hereunto duly authorized in Marietta, Pennsylvania on June 22, 2007.

DONEGAL MUTUAL INSURANCE
COMPANY 401(k) PLAN

By: /s/ Donald H. Nikolaus
Donald H. Nikolaus, Trustee

By: /s/ Jeffrey D. Miller
Jeffrey D. Miller, Trustee

By: /s/ Daniel J. Wagner
Daniel J. Wagner, Trustee

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DONEGAL MUTUAL INSURANCE COMPANY
401(k) PLAN
EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
23.1	Consent of Beard Miller Company LLP(filed herewith)