KPMG

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Des Moines, Iowa 50309-2530

Independent Auditors' Report

The Board of Directors
Le Mars Mutual Insurance Company of Iowa:

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of Le Mars Mutual Insurance Company of Iowa (the Company) as of December 31, 2002 and 2001, and the related statutory statements of operations, surplus, and cash flow for the years then ended. These 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 audits 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.

As described more fully in note 2 to the financial statements, the Company prepared these financials statements using accounting practices prescribed or permitted by the Iowa Department of Commerce, Insurance Division, which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements on the variances between the statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of LeMars Mutual Insurance Company as of December 31, 2002 and 2001, or the results of its operations or its cash flow for the years then ended.

Also, in our opinion, the financials statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of LeMars Mutual Insurance Company as of December 31, 2002 and 2001, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 2.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included in the accompanying schedules of supplemental investment risks interrogatories and summary investments is presented for the purpose of additional analysis and is not a required part of the basic financial statements. Such information 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.

KPMG LLP

March 21, 2003

LE MARS MUTUAL INSURANCE COMPANY OF IOWA

Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2002 and 2001

Admitted Assets		2002	2001
Cash and invested assets:			
Bonds, at amortized cost (market value $20,882,779 and $22,818,183)	$	20,275,194	22,647,576
Stocks:			
At market (cost $47,870 and $4,372,523)		124,902	4,727,069
Subsidiary, at book value (cost $40,252)		40,067	40,202
Mortgage loans on real estate		2,873	5,485
Real estate, net of accumulated depreciation of $953,918 in 2002 and $912,006 in 2001		684,334	726,246
Cash		794,003	2,873,710
Short-term investments, at cost which approximates fair value		10,347,678	15,846
Total cash and invested assets		32,269,051	31,036,134
Premiums and agents' balances in course of collection		3,051,020	4,491,404
Premium installments booked but deferred and not yet due		507,146	592,385
Reinsurance recoverable on paid losses		—	153,555
Data processing equipment, net of accumulated depreciation of $1,004,614 in 2002 and $931,973 in 2001		100,853	95,679
Accrued investment income		258,569	302,191
Federal income tax receivable		21,863	—
Other assets		9,066	9,905
Total admitted assets	$	36,217,568	36,681,253
Liabilities and Surplus			
Liabilities:			
Losses	$	10,900,874	13,113,801
Loss adjustment expenses		1,853,000	1,336,297
Accrued expenses and taxes (other than federal income taxes)		905,615	949,203
Unearned premiums		8,803,096	10,295,742
Ceded reinsurance premiums payable		(270,069)	748,237
Amounts withheld for account of others		28,791	8,244
Advanced premiums		—	374,917
Drafts outstanding		1,323,052	1,077,266
Total liabilities		23,544,359	27,903,707
Surplus note		4,000,000	—
Unassigned surplus		8,673,209	8,777,546
Total surplus		12,673,209	8,777,546
Total liabilities and surplus	$	36,217,568	36,681,253

See accompanying notes to statutory financial statements.

LE MARS MUTUAL INSURANCE COMPANY OF IOWA

Statutory Statements of Operations

Years ended December 31, 2002 and 2001

		2002	2001
Underwriting operations:			
Premiums earned	$	20,958,210	25,576,530
Losses and expenses incurred:			
Losses		12,156,957	16,497,535
Loss adjustment expenses		2,524,097	2,890,248
Other underwriting expenses		7,092,291	7,750,315
		21,773,345	27,138,098
Net underwriting loss		(815,135)	(1,561,568)
Investment operations:			
Interest earned		1,561,328	1,497,164
Dividends earned		23,227	118,975
Rent (Company occupancy of home office)		180,000	180,000
Net realized capital losses		(175,989)	(996,777)
		1,588,566	799,362
Less investment expenses		663,305	639,685
Net investment income		925,261	159,677
Other income, net		296,714	387,344
Income (loss) before Federal income tax expense		406,840	(1,014,547)
Income tax (benefit) expense		(21,863)	274
Net income (loss)	$	428,703	(1,014,821)

See accompanying notes to statutory financial statements.

LE MARS MUTUAL INSURANCE COMPANY OF IOWA

Statutory Statements of Surplus

Years ended December 31, 2002 and 2001

		2002	2001
Unassigned surplus:			
Balance at beginning of year	$	8,777,546	10,058,388
Net income (loss)		428,703	(1,014,821)
Change in net unrealized capital gains		(183,248)	(617,065)
Change in net deferred income tax		11,190	4,410,666
Change in nonadmitted assets		60,715	(4,452,873)
Change in surplus note		4,000,000	—
Prior period adjustment		(421,697)	—
Cumulative effect of changes in accounting principles		—	267,404
Change in statutory regulation (Iowa Code Sec 515.35)		—	(83,955)
Change in deferred tax asset related to unrealized loss		—	209,802
Balance at end of year	$	12,673,209	8,777,546

See accompanying notes to statutory financial statements.

LE MARS MUTUAL INSURANCE COMPANY OF IOWA

Statutory Statements of Cash Flow

Years ended December 31, 2002 and 2001

		2002	2001
Cash from operations:			
Premiums collected, net	$	19,585,646	24,344,605
Losses and loss adjustment expenses paid, net		(16,352,854)	(19,713,988)
Underwriting expenses paid		(7,049,325)	(7,724,041)
Cash used for underwriting		(3,816,533)	(3,093,424)
Net investment income		1,175,816	1,302,820
Finance and service charges		288,419	433,220
Other expense		—	(57,237)
Income taxes paid		—	(274)
Net cash used for operations		(2,352,298)	(1,414,895)
Cash from investments:			
Proceeds from investments sold, matured, or repaid:			
Bonds		7,988,095	14,049,364
Stocks		13,155,463	31,244,907
Mortgage loans		2,612	2,375
Total investment proceeds		21,146,170	45,296,646
Cost of investments acquired:			
Bonds		5,680,708	14,327,925
Stocks		8,991,946	28,176,843
Total investments acquired		14,672,654	42,504,768
Net cash provided from investments		6,473,516	2,791,878
Cash from financing and miscellaneous sources:			
Proceeds from surplus note		4,000,000	—
Other cash provided		130,907	195,722
Net cash provided from financing and miscellaneous		4,130,907	195,722
Net change in cash and short-term investments		8,252,125	1,572,705
Cash and short-term investments at beginning of year		2,889,556	1,316,851
Cash and short-term investments at end of year	$	11,141,681	2,889,556

See accompanying notes to statutory financial statements.

(1) Company Operations

Le Mars Mutual Insurance Company of Iowa (the Company) operates as a property and casualty insurance company which underwrites primarily private passenger automobile liability and physical damage coverages. The Company also offers 30 other products with emphasis on commercial packages, personal insurance packages, and farm lines. The Company markets its products through independent agencies, and business is written in the states of Iowa, South Dakota, Oklahoma, Nebraska, and North Dakota. Iowa accounted for 47% of 2002 direct written premiums. The Company operates as a mutual insurer, to which ownership vests in its policyholders, and control of operations lies in an elected board of directors.

On February 12, 2002, the board of directors of the Company approved a plan of operations that resulted in an affiliation with Donegal Mutual Insurance Company (Donegal). (See additional information in note 10.) The plan of operations of the Company included the following steps to be taken to restore its underwriting profitability: (1) rate increases in all lines of business consistent with actuarial indications reflecting loss trending, coupled with certain product modifications, designed to restore underwriting profitability; (2) re-underwriting the Company's entire book of business, effective upon the anniversary dates of policies in a 12 month period beginning within 90 days of Donegal's surplus note investment; (3) termination of agents with a demonstrated history of producing unprofitable business, low premium volume, or unacceptable risk selections; (4) reduction of the Company's expense ratio through the consolidation of certain "back office" functions with Donegal; (4) reduction of employment levels consistent with the consolidation of functions noted above; and (5) review of existing reinsurance agreements to obtain the most cost effective available coverages.

(2) Summary of Significant Accounting Policies

(a) *Basis of Presentation*

The Company prepares its statutory financial statements in conformity with accounting practices prescribed or permitted by the Iowa Department of Commerce, Insurance Division. Effective January 1, 2001, insurance companies domiciled in the State of Iowa are required to prepare their statutory financial statements in accordance with the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual* subject to any deviations prescribed or permitted by the State of Iowa insurance commissioner. The Company is currently applying only prescribed accounting practices.

Accounting changes adopted to conform to the provisions of the NAIC *Accounting Practices and Procedures Manual* – version effective January 1, 2001 are reported as changes in accounting principles. The cumulative effect of changes in accounting principles is reported as an adjustment to unassigned surplus in the period of the change in accounting principle. The cumulative effect is the difference between the amount of unassigned surplus at the beginning of the year and the amount that would have been reported at that date if the new accounting principles had been applied retroactively for all prior periods. As a result of these changes, the Company reported a cumulative effect change of accounting principle that increased unassigned surplus $267,404 as of January 1, 2001. This total adjustment of $267,404 related to the elimination of excess statutory reserves.

Statutory accounting practices, in accordance with the NAIC *Accounting Practices and Procedures Manual*, vary in some respects from accounting principles generally accepted in the United States of America (GAAP) and include the following:

1. Investments, other than investments in affiliates, are carried at values prescribed by the NAIC. Investments in bonds and short-term investments are generally carried at amortized cost, with changes in unrealized capital gains and losses not reflected in the statutory financial statements. GAAP requires investments, other than investments in subsidiaries, to be classified as held-to-maturity, trading, or available-for-sale. Held-to-maturity securities are carried at amortized cost; trading securities are carried at fair value with the changes in fair value included in the statutory statements of income; and available-for-sale securities are carried at fair value with the changes in fair value reflected as a separate component of equity.

2. Investments in subsidiaries are carried at the net equity values as prescribed by the NAIC. Changes in equity values related to earnings and other equity changes are reflected in surplus as charges or credits to unrealized gains and losses. GAAP requires subsidiaries to be consolidated.

3. Certain assets designated as "nonadmitted assets" (principally deferred tax assets not recoverable within a year, office furniture, and equipment) are charged directly to unassigned surplus.

4. Acquisition costs, such as commissions and other costs relating to acquiring new and renewal business, are charged to current operations as incurred, whereas the premiums are taken into earnings over the periods covered by the policies. Under GAAP, acquisition costs are capitalized and charged to operations as the revenues are recognized.

5. Deferred Federal income taxes are provided for the tax effects of certain income and expense items recognized for income tax purposes in different years than for financial reporting purposes. The change in the deferred tax asset or liability is reflected in surplus. GAAP requires the change to be reported in income. Admittance testing may result in a charge to surplus for nonadmitted portions of the deferred tax asset. For GAAP reporting, a valuation allowance may be recorded against the deferred tax asset.

6. Assets and liabilities are net of amounts ceded to reinsurers rather than being presented on a gross basis for GAAP.

7. Rental income on home office properties is recognized by the Company and a similar amount of rental expense is recognized as a charge for this office space.

8. The statutory statements of cash flow do not include classifications consistent with GAAP, and a reconciliation of net income to net cash provided by operating activities is not provided.

9. The statutory financial statements do not include a statement of comprehensive income.

10. The Company's subsidiary investment is accounted for under the equity method rather than being consolidated.

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11. Cumulative effect of change in accounting is reported as an adjustment to surplus in the period of the change in accounting principle. GAAP requires that cumulative effect of a change in accounting be reported as a component of net income.

The differences between GAAP and statutory accounting principles have not been determined and are presumed to be material.

The preparation of financial statements in conformity with accounting practices prescribed or permitted by the Iowa Department of Commerce, Insurance Division 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 to revenues and expenses during the reporting period. Actual results could differ from those estimates.

(b) Business Risks

The Company operates in a business environment which is subject to various risks and uncertainties. Such risks and uncertainties include interest rate risk, legal and regulatory changes, and default risk.

Interest rate risk is the potential for interest rates to change, which can cause changes in the value of investments. Interest rate exposure for the Company's investment portfolio is managed by investing in high quality investments with appropriate lengths of maturities.

The potential also exists for changes in the legal or regulatory environment in which an insurer operates, which can create additional costs and expenses not anticipated by an insurer in pricing its products. In other words, regulatory initiatives may create costs for the insurer beyond those recorded in the statutory financial statements. The Company mitigates this risk by closely monitoring the regulatory environment to anticipate changes and by using underwriting practices which identify and minimize the potential adverse impact of this risk.

Default risk is the risk that issuers of securities owned by an insurer may default or other parties, including reinsurers, may not be able to pay amounts due to an insurer. The Company minimizes this risk by adhering to a conservative investment strategy, maintaining sound reinsurance and credit and collection policies, and providing allowances or reserves for any amounts deemed uncollectible.

The NAIC has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory capital and surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to protect the Company from the various risks which it faces. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. The Company continues to monitor that its internal capital levels are in excess of the minimum capital requirements for all RBC action levels.

(c) Valuation of Investments

Investment securities are carried in accordance with valuations established by the NAIC.

Bonds are recorded at amortized cost unless otherwise indicated under the valuation standards of the NAIC. Mortgage-backed securities are amortized using the prospective method. Prepayment assumptions were obtained from investment managers. Common stocks of unaffiliated companies are recorded at fair value, with the net unrealized gains or losses attributable to the adjustment from cost to fair value reflected in unassigned surplus.

Impairments in the value of securities held by the Company, considered to be other than temporary, are recorded as a reduction of the cost of the security, and a corresponding realized loss is recognized in the statements of operations. The Company reviews all securities on a quarterly basis and recognizes impairment after evaluating various subjective and objective factors, such as the financial condition of the issuer, market, and industry.

Investment in subsidiary company, ILM Limited, is accounted for using the equity method. The Company records its equity in its wholly owned subsidiary as credits or charges to surplus. Investment in subsidiary company is carried at the underlying statutory net equity.

Investment in real estate is recorded at cost less accumulated depreciation. Depreciation is computed using the accelerated cost recovery system for statutory and tax reporting purposes over the estimated useful life of the property (approximately 40 years).

Other invested assets consist of mortgage loans, which are carried at unpaid principal balances, and investments in transit, which are carried at the transaction settlement value.

Premiums and discounts on bonds are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Realized gains and losses on investments are determined on the basis of specific identification of securities sold.

(d) Cash

The Company's cash balance of $794,003 at December 31, 2002 is held at one financial institution, and therefore a significant amount of the cash balance is in excess of the amounts insured by the Federal Deposit Insurance Corporation.

(e) Data Processing Equipment

Data processing equipment is recorded at cost less accumulated depreciation. Depreciation expense is provided using an accelerated method over the estimated useful life of the equipment for statutory and tax reporting purposes.

(f) Liabilities for Losses and Loss Adjustment Expenses

The Company provides liabilities for losses based upon the accumulation of individual claim estimates, reports from ceded reinsurers for assumed reinsurance, and estimates for unreported claims based upon prior years' experience, adjusted for current trends. These liabilities represent estimates of the ultimate net cost, after deduction of amounts for ceded reinsurance placed with reinsurers, of all losses and claims incurred through December 31 of each year. The Company provides liabilities for loss adjustment expenses by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses. As of December 31, 2002, the

Company no longer anticipates salvage and subrogation receipts when establishing carried reserves. The impact on liabilities for losses and loss adjustment expenses is immaterial.

Management believes that the provisions for losses and loss adjustment expenses at December 31, 2002 are adequate to cover the ultimate liability of losses and claims incurred to date. Since the liability provisions are based on estimates, the ultimate liability may be more or less than such provisions. Adjustments of the estimated liability, based on subsequent developments, are included in current operations.

(g) Premium Income Recognition

Premiums are recognized as revenue ratably over the terms of the respective policies. Unearned premiums are computed on a daily pro rata basis over the terms of the policies and are stated after deduction for reinsurance placed with other insurers.

(h) Federal Income Taxes

Current income taxes incurred are charged to the statement of income based on tax returns for the current year and tax contingencies for current and all prior years, to the extent not previously provided.

Deferred 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. Gross deferred tax assets and liabilities are measured using enacted tax rates and are considered for admitted asset status according to the admissibility tests as set forth by the NAIC. Changes in deferred tax assets and deferred tax liabilities, including changes attributable to changes in tax rates, are recognized as a component of surplus.

The Company files a consolidated Federal income tax return with its wholly owned subsidiary, ILM Limited. Consolidated Federal income tax liability or refund is allocated among the entities on a separate company basis and apportioned to each company on the basis of regular corporate income tax.

(3) Fair Value of Financial Instruments

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

?? *Bonds:* The fair value is based upon market prices provided by the NAIC (note 4).

?? *Common stock of unaffiliated companies:* The fair value is based upon the quoted market prices where available or from independent pricing services. Common stock of unaffiliated companies is carried at fair value (note 4).

?? *Cash and short-term investments:* Due to their short-term nature, their carrying amounts approximate fair value.

?? *Other financial instruments:* Due to their short-term nature, their carrying amounts approximate fair value.

The fair value estimates are based on pertinent information available to management as of December 31, 2002 and 2001. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been revalued for purposes of these financial statements since that date, and current estimates of fair value may differ.

(4) Investments

The following is a schedule of amortized cost and estimated fair value of investments in bonds and equity securities as of December 31, 2002 and 2001.

	2002			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
United States Treasury securities and agencies	$ 4,872,463	164,346	9	5,036,800
Special revenue	499,768	5,232	—	505,000
Industrial and miscellaneous	13,869,488	494,474	95,262	14,268,700
Mortgage backed	1,033,475	38,804	—	1,072,279
	$ 20,275,194	702,856	95,271	20,882,779
Equity securities:				
Common stock – unaffiliated	$ 47,870	78,535	1,503	124,902
Common stock – affiliated	40,252	—	185	40,067
	$ 88,122	78,535	1,688	164,969

	2001			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
United States Treasury securities and agencies	$ 6,475,590	21,153	4,456	6,492,287
Special revenue	—	—	—	—
Industrial and miscellaneous	14,587,535	259,831	105,921	14,741,445
Mortgage backed	1,584,451	—	—	1,584,451
	$ 22,647,576	280,984	110,377	22,818,183
Equity securities:				
Common stock – unaffiliated	$ 4,372,523	433,047	78,501	4,727,069
Common stock – affiliated	40,252	—	50	40,202
	$ 4,412,775	433,047	78,551	4,767,271

The amortized cost of investments in bonds at December 31, 2002 is shown below by contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay with or without call or prepayment penalties.

		Amortized cost	Estimated market value
Due in one year or less	$	3,110,515	3,153,300
Due after one year through five years		4,327,908	4,556,500
Due after five years through ten years		7,334,275	7,462,200
Due after ten years		4,469,021	4,638,500
Mortgage-backed securities		1,033,475	1,072,279
	$	20,275,194	20,882,779

Realized capital gains and losses were as follows for 2002 and 2001:

		2002	2001
Realized capital gains – bonds	$	54,545	340,498
Realized capital gains – stocks		351,305	461,851
Total realized capital gains		405,850	802,349
Realized capital losses – bonds		69,399	32,087
Realized capital losses – stocks		512,440	1,767,039
Total realized capital losses		581,839	1,799,126
Net realized capital losses	$	(175,989)	(996,777)

Bonds having an amortized value of $1,922,345 at December 31, 2002 have been deposited with various insurance regulatory authorities as required by law.

The following is a schedule of investment income earned during the years ended December 31, 2002 and 2001.

		2002	2001
U.S. government bonds	$	541,414	335,330
Other bonds (unaffiliated)		932,224	1,139,379
Common stocks (unaffiliated)		23,227	118,975
Mortgage loans		92	588
Real estate		180,000	180,000
Cash and short term investments		87,598	21,867
Net realized capital losses		(175,989)	(996,777)
Investment income earned	$	1,588,566	799,362

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(5) Employee Benefit Plans

The Company's 401(k) defined contribution plan includes a profit sharing provision and is available to all employees who have reached 20-1/2 years of age and completed 6 months of service. Eligible employees are allowed to annually contribute from 1% to 15% of compensation up to a maximum of $10,500 in 2002 and 2001. The Company matches 50% of the participating employee contributions, up to 3% of the employee-elected deferral (maximum Company match of 1.5% of annual compensation). Participants are immediately 100% vested in their own contributions. Participants are vested in employer contributions based on years of service, and a participant is 100% vested after 5 years of service or upon attaining a specified age and service requirement. The Company made matching contributions of $27,250 and $31,034 to the 401(k) defined contribution plan in 2002 and 2001, respectively.

The Company made an additional discretionary contribution of 3% of compensation to participants' accounts, and a discretionary contribution (profit sharing) is computed in accordance with a formula based on the combined ratio performance of the Company. The Company made discretionary contributions to the 401(k) profit sharing plan of $68,422 and $57,939 for the years ended December 31, 2002 and 2001, respectively.

(6) Income Taxes

The actual Federal income tax expense differs from the expected tax benefit computed by applying the United States Federal income tax rate of 34% to loss before Federal income tax expense. The sources and tax effect of these differences are as follows:

	2002 Amount	2002 Percent of pretax income	2001 Amount	2001 Percent of pretax income
Computed "expected" Federal income tax benefit	$ 138,326	34.0 %	$ (344,946)	34.0 %
Increases (reductions) in taxes resulting from:				
Tax-exempt income	(3,507)	(1.0)	(14,082)	1.0
Unearned premium adjustments	(101,500)	(25.0)	(120,718)	12.0
Loss reserve discounting	(42,362)	(10.0)	(18,827)	2.0
Net operating loss carryforward generated	96,068	24.0	171,759	(17.0)
Capital loss carryforward	49,941	12.0	320,254	(31.0)
AMT credit	(21,863)	(5.0)	—	0.0
Premium adjustment through surplus	(143,377)	(35.0)	—	0.0
Other	6,411	1.0	6,560	(1.0)
Total Federal income tax expense	$ (21,863)	(5.0) %	$ —	0.0 %
Foreign taxes	—		274	
Total income tax expense	$ (21,863)		$ 274	

Total income tax benefit:

	Tax	Effective rate
Income tax benefit computed at statutory tax rate	$ 138,326	34%
Dividends received deduction	(4,126)	(1%)
Premium adjustment through surplus	(143,377)	(35%)
Other items, including prior year over-accrual	(23,876)	(6%)
Total statutory income tax benefit	$ (33,053)	(8%)
Current income taxes incurred	$ (21,863)	(5%)
Change in net deferred income tax assets	(11,190)	(3%)
Total statutory income tax benefit	$ (33,053)	(8%)

(Continued)

Current income taxes incurred consist of the following major components:

		2002	2001
Federal	$	(21,863)	—
Foreign		—	274
Current income taxes incurred	$	(21,863)	274

For Federal income tax purposes, the Company has net operating loss carryforwards of approximately $8,044,000 as of December 31, 2002, which will begin to expire in 2008. The Company has an alternative minimum tax credit carryforward of approximately $412,000 at December 31, 2002 with no expiration date. There are no income taxes incurred in the current year or prior year that will be available for recoupment in the event of future losses.

The components of the net deferred income tax assets recognized in the Company's assets, liabilities, surplus, and other funds are as follows:

		2002	2001
Total deferred tax assets	$	4,705,387	4,770,388
Total deferred tax liabilities		(35,872)	(149,920)
Net deferred tax assets (admitted and nonadmitted)		4,669,515	4,620,468
Deferred tax assets nonadmitted		(4,669,515)	(4,620,468)
Net admitted deferred tax asset	$	—	—
Increase (decrease) in deferred tax assets nonadmitted	$	49,047	(415,121)

(Continued)

The main components of the deferred tax assets and deferred tax liabilities are as follows:

	Statutory	Tax	Difference	Tax effect
Deferred tax assets:				
Losses and loss adjustment expenses unpaid (gross)	$ 12,753,874	11,429,175	1,324,699	450,398
Unearned premiums	8,803,096	7,042,477	1,760,619	598,610
Other – including nonadmitted assets	—	362,153	362,153	123,132
Net operating loss carryforward			8,043,970	2,734,950
Capital loss carryforward			1,135,068	385,923
AMT credit carryforward				412,374
Total deferred tax assets	21,556,970	18,833,805	12,626,509	4,705,387
Deferred tax assets not admitted				4,669,515
Admitted deferred tax assets				35,872
Deferred tax liabilities:				
Market discount accretion (bonds)	20,275,194	20,246,534	28,660	9,744
Unrealized gains (stocks)	164,969	88,122	76,847	26,128
Total deferred tax liabilities	20,440,163	20,334,656	105,507	35,872
Net admitted deferred tax assets				$ —

(Continued)

The changes in the main components of deferred tax assets and liabilities are as follows:

		December 31, 2002	December 31, 2001	Change
Deferred tax assets:				
Losses and loss adjustment expenses unpaid (gross)	$	450,398	552,731	(102,333)
Unearned premiums		598,610	700,110	(101,500)
Other – including nonadmitted assets		123,132	109,209	13,923
Net operating loss carryforward		2,734,950	2,653,847	81,103
Capital loss carryforward		385,923	320,254	65,669
AMT credit carryforward		412,374	434,237	(21,863)
Total deferred tax assets		4,705,387	4,770,388	(65,001)
Deferred tax assets not admitted		(4,669,515)	(4,620,468)	(49,047)
Admitted deferred tax assets		35,872	149,920	(114,048)
Deferred tax liabilities:				
Market discount accretion (bonds)		9,744	22,723	(12,979)
Unrealized gains (stocks)		26,128	120,529	(94,401)
Other		—	6,668	(6,668)
Total deferred tax liabilities		35,872	149,920	(114,048)
Net admitted deferred tax assets	$	—	—	—

(7) Liabilities for Losses and Loss Adjustment Expenses

Activity in the liabilities for losses and loss adjustment expenses in 2002 and 2001 is summarized as follows:

		2002	2001
Net balance at beginning of year	$	14,450,098	14,897,183
Incurred related to:			
Current year		17,203,188	19,756,319
Prior year		(2,522,134)	(368,536)
Total incurred losses and loss adjustment expenses		14,681,054	19,387,783
Paid related to:			
Current year		10,708,272	17,459,892
Prior year		5,669,006	2,374,976
Total paid losses and loss adjustment expenses		16,377,278	19,834,868
Net balance at end of year	$	12,753,874	14,450,098

(Continued)

The reserving process relies on the basic assumption that past experience, adjusted for the effect of current developments and likely trends, is an appropriate basis for predicting future events. Reserve amounts are necessarily based on management's informed estimates; as other data becomes available and is reviewed these estimates and judgments are revised, resulting in increases and decreases to existing reserves. As a result of changes in estimates of insured events in prior years, the provision for losses and loss adjustment expenses decreased $2,522,134 and $368,536 in 2002 and 2001, respectively. Developments for losses and loss adjustment expenses in 2002 on prior years were primarily due to decreased estimates for settlement of claims to reflect current trends for ultimate settlement of loss and loss adjustment expenses particularly related to automobile liability. See note 8 for liabilities for losses and loss adjustment expenses on reinsurance ceded.

In establishing liabilities for losses and loss adjustment expenses, management considers exposure the Company may have to environmental claims. Because the emphasis of the Company's business is primarily on personal lines and small commercial business and the reported environmental claim activity is minimal, management believes exposure to material liability on such claims to be remote as of December 31, 2002.

(8) Reinsurance

The Company cedes insurance to other insurers in the ordinary course of business for the purpose of limiting its maximum loss exposure through diversification of its risks. Reinsurance contracts do not relieve the Company from its obligations to policyholders as the primary insurer. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible. The Company's reinsurance recoverable is primarily with one unaffiliated reinsurer, General Reinsurance Company, which is an entity rated A++ by A. M. Best and Company, an industry accepted rating organization. The Company's assumed insurance is primarily from mandatory and voluntary pools and associations for workers' compensation and automobile insurance.

The effects of reinsurance on premiums written and earned, losses and loss adjustment expenses incurred, unearned premiums, and liabilities for losses and loss adjustment expenses for 2002 and 2001 were as follows:

	2002			
	Direct	**Assumed**	**Ceded**	**Net**
Premiums written	$ 20,883,735	71,527	1,489,698	19,465,564
Premiums earned	23,102,933	85,912	2,230,635	20,958,210
Losses and loss adjustment expenses incurred	15,089,915	(41,629)	367,232	14,681,054
Unearned premiums	8,936,416	28,257	161,577	8,803,096
Liabilities for losses and loss adjustment expenses	15,413,344	650,183	3,309,653	12,753,874

(Continued)

	2001			
	Direct	Assumed	Ceded	Net
Premiums written	$ 26,894,402	82,120	3,175,247	23,801,275
Premiums earned	28,875,554	76,166	3,375,190	25,576,530
Losses and loss adjustment expenses incurred	23,722,193	(14,832)	4,319,578	19,387,783
Unearned premiums	11,155,614	42,642	902,514	10,295,742
Liabilities for losses and loss adjustment expenses	17,922,458	713,068	4,185,428	14,450,098

(9) Commitments and Contingencies

The Company leases certain computer software and hardware from unaffiliated companies under operating leases expiring in various years through 2005. Rental expense amounted to $60,406 and $162,302 for the years ended December 31, 2002 and 2001, respectively. Future minimum lease payments at December 31, 2002 under noncancelable operating leases for each of the three remaining years of the leases from 2003 to 2005 are $41,335; $27,900; and $6,975; respectively.

The Company is party to various lawsuits arising in the normal course of business. The Company believes the resolution of those lawsuits will not have a material adverse impact on its financial condition or its results of operations.

(10) Related Party Transactions

At a Special Meeting of Members of the Company held on Thursday, April 25, 2002, the policyholders approved the Note Purchase Agreement dated as of February 21, 2002 between the Company and Donegal Mutual Insurance Company and the actions contemplated thereby, including the following:

- The issuance of a $4,000,000 surplus note by the Company to Donegal in exchange for a cash payment of $4,000,000 from Donegal that will increase the surplus of the Company;
- The resignation of five members of the board of directors of the Company and the election of five designees of Donegal as members of the nine-person board of directors, thereby transferring control of the Company to Donegal;
- The adoption of the plan of operations by the board of directors of the Company (discussed in note 1) that is intended to restore the Company to underwriting profitability and improve its financial condition, with the ultimate goal of converting the Company from a mutual company owned by the members to a stock company owned by Donegal following a demutualization;
- The execution of a services agreement by Donegal and the Company whereby Donegal would provide advice and assistance to the management of the Company in pursuing the objectives of the plan of operations;
- The Company entering into employment agreements with three of its principal executive officers;

- The adoption of Amended and Substituted Articles of Incorporation; and
- The approval of Amended and Restated Bylaws.

The surplus note was issued on June 12, 2002 for $4,000,000 in cash. The note is due on December 31, 2006 or the date when Donegal designees cease to constitute a majority of the members of the Company's board of directors. Interest shall accrue at the lesser of 8% or the sum of the prime rate plus 2%. Under the terms of the surplus note, any payment of principal or accrued interest thereupon, are subject to the prior approval in writing of the Commissioner of Insurance of the State of Iowa. For the purpose of determining surplus, the outstanding principal amount of, and the accrued interest on, this surplus note is restricted as to payment and is not recorded as a liability of the Company. No interest was paid or accrued in 2002. The payment of the note and interest is subordinate to the conversion of the Company to a stock company. Donegal has the option to cancel the note in exchange for shares of stock valuing the same amount as the note.

Donegal provides advice and consulting services to the Company in connection with, but not limited to, the following aspects of the operations of the Company: data processing, investment portfolio, tax administration, financial services, accounting services, policyholder services, insurance services, personnel and professional services, underwriting reporting services, reinsurance, and such other services relating to the insurance operations of the Company as are requested from time to time by its board of directors. Donegal charged the Company $61,255 for services rendered pursuant to this agreement in 2002. Donegal paid the Company $38,602 during 2002 for computer programming services performed by the Company for Donegal. Amounts due are settled on a monthly basis.

(11) Reconciliation to Statutory Filing

During 2002, an error was discovered in the calculation of ceded premiums recorded in 2001 and prior years. The correction of this error was shown as a reduction of 2002 net premiums earned in the financial statements submitted to regulatory authorities. These statutory financial statements present this adjustment through surplus.

The following is a reconciliation of differences between these statutory financial statements and the annual statements filed with the Insurance Commissioners:

	2002	
	Unassigned surplus	**Net income**
As reported to regulatory authorities	$ 12,673,209	7,006
Adjustment to premiums earned	421,697	421,697
Prior period adjustment	(421,697)	—
As reported in the attached financial statements	$ 12,673,209	428,703

LE MARS MUTUAL INSURANCE COMPANY OF IOWA

Schedule of Supplemental Investment Risks Interrogatories

December 31, 2002

1) Total admitted assets: $ 36,217,568

2) Ten largest exposures to a single issuer/borrower/investment:

Issuer	Investment category		Amount	Percentage of total
General Motors Acceptance Corp.	Bonds	$	999,953	2.8%
Ford Motor Credit	Bonds		759,852	2.1%
Daimler Chrysler	Bonds		747,416	2.1%
Sears Roebuck	Bonds		736,338	2.0%
Bear Sterns Cos., Inc.	Bonds		504,626	1.4%
J.P. Morgan & Co., Inc.	Bonds		503,299	1.4%
General Electric Capital Corp.	Bonds		500,004	1.4%
Bank of America Corp	Bonds		499,999	1.4%
Caterpillar Finance Service Corp.	Bonds		499,978	1.4%
Eastman Kodak Co.	Bonds		499,647	1.4%

3) Total admitted assets held in bonds and preferred stocks by NAIC rating:

Bonds		Amount	Percentage	Stocks		Amount	Percentage
NAIC-1	$	16,742,594	46.2%	P/PSF-1	$	—	0.0%
NAIC-2		3,532,600	9.8%	P/PSF-2		—	0.0%
NAIC-3		—	0.0%	P/PSF-3		—	0.0%
NAIC-4		—	0.0%	P/PSF-4		—	0.0%
NAIC-5		—	0.0%	P/PSF-5		—	0.0%
NAIC-6		—	0.0%	P/PSF-6		—	0.0%

4) Admitted assets held in foreign investments and unhedged foreign currency exposure:

		Amount	Percentage
Foreign-currency denominated investments of	$	—	0.0%
Foreign-currency denominated supporting insurance liabilities of		—	0.0%
Excluding Canadian investments and currency exposure of		—	0.0%

5) Assets held in Canadian investments and unhedged Canadian currency exposure:

		Amount	Percentage
Canadian-currency denominated investments of	$	—	0.0%
Canadian denominated supporting insurance liabilities of		—	0.0%

		Amount	Percentage
6) Admitted assets held in investments with contractual sales restrictions:	$	—	0.0%

7) Admitted assets held in the ten largest equity interests:

Issuer	Investment category		Amount	Percentage
None		$	—	0.0%

		Amount	Percentage
8) Aggregate statement value of investments held in nonaffiliated, privately placed equities:	$	—	0.0%

		Amount	Percentage
9) Admitted assets held in general partnership interests:	$	—	0.0%

(Continued)

LE MARS MUTUAL INSURANCE COMPANY OF IOWA

Schedule of Supplemental Investment Risks Interrogatories

December 31, 2002

		Amount	Percentage
10)	Admitted assets held in mortgage loans:	$ —	0.0%
		Amount	**Percentage**
11)	Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in the Annual Statement Schedule A.	$ —	0.0%

12) Amount of total admitted assets subject to the following types of agreements:

Agreement type	At year end		At end of each quarter 1st Qtr	2nd Qtr	3rd Qtr
Securities lending	$ —	0.0%	$ —	0.0%	0.0%
Repurchase agreements	—	0.0%	—	0.0%	0.0%
Reverse repurchase	—	0.0%	—	0.0%	0.0%
Dollar repurchase	—	0.0%	—	0.0%	0.0%
Dollar reverse repurchase	—	0.0%	—	0.0%	0.0%

13) Warrants not attached to other financial instruments, options, caps, and floors:

	Owned		Written	
Hedging	$ —	0.0%	$ —	0.0%
Income generation	—	0.0%	—	0.0%
Other	—	0.0%	—	0.0%

14) Potential exposure for collars, swaps, and forwards:

	At year end		At end of each quarter 1st Qtr	2nd Qtr	3rd Qtr
Hedging	$ —	0.0%	$ —	—	—
Income generation	—	0.0%	—	—	—
Replications	—	0.0%	—	—	—
Other	—	0.0%	—	—	—

15) Potential exposure for future contracts:

	At year end		At end of each quarter 1st Qtr	2nd Qtr	3rd Qtr
Hedging	$ —	0.0%	$ —	—	—
Income generation	—	0.0%	—	—	—
Replications	—	0.0%	—	—	—
Other	—	0.0%	—	—	—

16) Ten largest investments included in the Write-ins for Invested Assets category included on the Summary Investment Schedule in the Annual Statement:

Investment	Amount	Percentage
None	$ —	0.0%

See accompanying independent auditors' report.

LE MARS MUTUAL INSURANCE COMPANY OF IOWA

Schedule of Summary Investments

December 31, 2002

Investment categories		Gross investment holdings			Admitted assets as reported in the annual statement	
Bonds:						
U.S. Treasury securities	$	360,902	1.1%	$	360,902	1.1%
U.S. Government agency and corporate obligations:						
Issued by U.S. Government agencies		—	0.0%		—	0.0%
Issued by U.S. Government-sponsored agencies		—	0.0%		—	0.0%
Foreign government		—	0.0%		—	0.0%
Securities issued by states, territories, and political subdivisions in the US:						
State, territory, and possession general obligations		—	0.0%		—	0.0%
Political subdivisions of states, territories, and possessions political subdivisions general obligations		—	0.0%		—	0.0%
Revenue and assessment obligations		499,768	1.5%		499,768	1.5%
Industrial development and similar obligations		—	0.0%		—	0.0%
Mortgage-backed securities:						
Pass-through securities:						
Guaranteed by GNMA		838,158	2.6%		838,158	2.6%
Issued by FNMA and FHLMC		4,706,880	14.6%		4,706,880	14.6%
Privately issued		—	0.0%		—	0.0%
Other mortgage-backed securities:						
Issued by FNMA, FHLMC, and GNMA		—	0.0%		—	0.0%
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FNMA, FHLMC		—	0.0%		—	0.0%
All other mortgage-backed securities		—	0.0%		—	0.0%
Other debt and other fixed income securities:						
Unaffiliated domestic securities		13,869,486	43.0%		13,869,486	43.0%
Unaffiliated foreign securities		—	0.0%		—	0.0%
Affiliated securities		—	0.0%		—	0.0%
Equity interests:						
Investments in mutual funds		—	0.0%		—	0.0%
Preferred stocks:						
Affiliated		—	0.0%		—	0.0%
Unaffiliated		—	0.0%		—	0.0%
Publicly traded equity securities:						
Affiliated		—	0.0%		—	0.0%
Unaffiliated		—	0.0%		—	0.0%
Tangible personal property under lease:						
Affiliated		—	0.0%		—	0.0%
Unaffiliated		—	0.0%		—	0.0%
Other equity securities:						
Affiliated		40,067	0.1%		40,067	0.1%
Unaffiliated		124,902	0.4%		124,902	0.4%
Mortgage loans:						
Construction and land development		—	0.0%		—	0.0%
Agricultural		—	0.0%		—	0.0%
Single family residential properties		2,873	0.0%		2,873	0.0%
Multifamily residential properties		—	0.0%		—	0.0%
Commercial loans		—	0.0%		—	0.0%
Real estate investments:						
Property occupied by company		684,334	2.1%		684,334	2.1%
Property held for production of income		—	0.0%		—	0.0%
Property held for sale		—	0.0%		—	0.0%
Policy loans		—	0.0%		—	0.0%
Receivable for securities		—	0.0%		—	0.0%
Cash and short-term investments		11,141,681	34.5%		11,141,681	34.5%
Write-in invested assets		—	0.0%		—	0.0%
Total invested assets	$	32,269,051	100.0%	$	32,269,051	100.0%

See accompanying independent auditors' report.

Le Mars Mutual Insurance Company of Iowa
Statutory Balance Sheet

	July 31, 2003 (Unaudited)
Assets	
Bonds	$26,969,236
Common stocks	164,870
Real estate	659,949
Cash	1,257,103
Short-term investments	3,808,927
Receivable for securities	300,000
Premiums receivable	3,811,419
EDP equipment and software	75,616
Accrued interest	282,709
Other	9,066
Total assets	$37,338,895
Liabilities and Surplus	
Liabilities	
Losses and loss expenses	$14,464,194
Unearned premiums	9,669,985
Accrued expenses	830,206
Reinsurance balances payable	56,939
Drafts outstanding	1,080,817
Other	14,735
Total Liabilities	26,116,876
Surplus	
Surplus Note	4,000,000
Unassigned surplus	7,222,019
Total surplus	11,222,019
Total liabilities and surplus	$37,338,895

Le Mars Mutual Insurance Company of Iowa
Statutory Statements of Operations
(Unaudited)

	Seven Months Ended July 31,	
	2003	2002
Net premiums earned	$10,286,789	$12,959,081
Losses incurred	6,890,856	7,684,282
Loss expenses incurred	1,227,102	1,386,730
Underwriting expenses	4,525,642	4,111,631
Underwriting loss	(2,356,811)	(223,562)
Investment income	727,988	479,611
Realized capital gains (losses)	3,155	(183,790)
Total investment income	731,143	295,821
Service fee income	138,553	179,224
Other income	4,498	6,497
Income (loss) before income taxes	(1,482,617)	257,980
Income taxes	---	---
Net income (loss)	$ (1,482,617)	$ 257,980

Le Mars Mutual Insurance Company of Iowa
Statutory Statement of Surplus
(Unaudited)
Seven Months Ended July 31, 2003

	2003
Balance, December 31, 2002	$12,673,209
Net income (loss)	(1,482,617)
Change in non-admitted assets	31,526
Unrealized investment losses	(99)
Balance July 31, 2003	$11,222,019