

AMERICAN FINANCIAL GROUP INC  
Form 10-Q  
November 09, 2007

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For the Quarterly Period Ended  
September 30, 2007

Commission File

No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under  
the Laws of Ohio

IRS Employer I.D.  
No. 31-1544320

One East Fourth Street, Cincinnati, Ohio 45202  
(513) 579-2121

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, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the Registrant is a shell company. Yes  No

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As of November 1, 2007, there were 115,415,620 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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AMERICAN FINANCIAL GROUP, INC.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

PART I

ITEM I - FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (unaudited)

(Dollars In Millions)

|  | September 30,<br><u>2007</u> | December 31,<br><u>2006</u> |
|--|------------------------------|-----------------------------|
| Assets:  |                              |                             |
| Cash and cash equivalents  | \$ 729.2                     | \$ 1,329.0                  |
| Investments:   |                              |                             |
| Fixed maturities:  |                              |                             |
| Available for sale - at fair value<br>(amortized cost - \$15,254.0 and \$14,663.0) | 15,114.7                     | 14,624.3                    |
| Trading - at fair value  | 275.9                        | 276.4                       |
| Equity securities - at fair value<br>(cost - \$958.0 and \$606.4)                  | 1,031.2                      | 729.4                       |
| Mortgage loans   | 346.5                        | 264.5                       |
| Policy loans   | 269.9                        | 267.1                       |
| Real estate and other investments  | <u>285.7</u>                 | <u>248.3</u>                |

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|   |                   |                   |
|---|-------------------|-------------------|
| Total cash and investments                                    | 18,053.1          | 17,739.0          |
| Recoverables from reinsurers and prepaid reinsurance premiums | 3,703.5           | 3,625.2           |
| Agents' balances and premiums receivable                      | 811.6             | 599.4             |
| Deferred policy acquisition costs                             | 1,382.9           | 1,266.9           |
| Other receivables   | 463.3             | 425.0             |
| Variable annuity assets (separate accounts)                   | 717.1             | 700.5             |
| Prepaid expenses and other assets                             | 779.9             | 577.3             |
|   | <u>204.5</u>      | <u>167.8</u>      |
| Goodwill  |                   |                   |
|   | <u>\$26,115.9</u> | <u>\$25,101.1</u> |
| Liabilities and Capital:                                      |                   |                   |
| Unpaid losses and loss adjustment expenses                    | \$ 6,216.8        | \$ 6,027.7        |
| Unearned premiums   | 1,892.0           | 1,653.9           |
| Annuity benefits accumulated                                  | 9,978.5           | 9,456.7           |
| Life, accident and health reserves                            | 1,472.2           | 1,414.7           |
| Payable to reinsurers   | 411.5             | 314.9             |
| Long-term debt  | 897.2             | 921.0             |
| Variable annuity liabilities (separate accounts)              | 717.1             | 700.5             |
| Accounts payable, accrued expenses and other liabilities      | <u>1,422.1</u>    | <u>1,398.9</u>    |
| Total liabilities   | 23,007.4          | 21,888.3          |
| Minority interest   | 95.6              | 283.9             |
| Shareholders' Equity:   |                   |                   |
| Common Stock, no par value                                    |                   |                   |
| - 200,000,000 shares authorized                               |                   |                   |
| - 115,530,808 and 119,303,928 shares outstanding              | 115.5             | 119.3             |
| Capital surplus   | 1,202.1           | 1,220.5           |
| Retained earnings   | 1,695.4           | 1,533.6           |
| Accumulated other comprehensive income (loss), net of tax     | <u>(.1)</u>       | <u>55.5</u>       |
| Total shareholders' equity                                    | <u>3,012.9</u>    | <u>2,928.9</u>    |
|   | <u>\$26,115.9</u> | <u>\$25,101.1</u> |

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF EARNINGS (unaudited)

(In Millions, Except Per Share Data)

|   | Three months ended<br><u>September 30,</u> |              | Nine months ended<br><u>September 30,</u> |                |
|---|--|--------------|---|----------------|
|   | <u>2007</u>                                | <u>2006</u>  | <u>2007</u>                               | <u>2006</u>    |
| Income:   |  |              |   |                |
| Property and casualty insurance premiums                | \$ 757.5                                   | \$ 730.9     | \$2,030.8                                 | \$1,925.0      |
| Life, accident and health premiums                      | 105.6                                      | 91.7         | 315.6                                     | 249.3          |
| Investment income                                       | 252.7                                      | 233.1        | 747.5                                     | 698.5          |
| Realized gains (losses) on securities                   | (7.1)                                      | (2.4)        | 11.6                                      | 19.9           |
| Other income  | <u>86.1</u>                                | <u>83.2</u>  | <u>260.8</u>                              | <u>234.9</u>   |
|   | 1,194.8                                    | 1,136.5      | 3,366.3                                   | 3,127.6        |
| Costs and Expenses:                                     |  |              |   |                |
| Property and casualty insurance:                        |  |              |   |                |
| Losses and loss adjustment expenses                     | 436.0                                      | 424.8        | 1,117.7                                   | 1,135.3        |
| Commissions and other underwriting expenses             | 219.7                                      | 225.3        | 638.4                                     | 567.2          |
| Annuity benefits  | 94.5                                       | 88.4         | 273.7                                     | 255.2          |
| Life, accident and health benefits                      | 87.1                                       | 69.1         | 258.0                                     | 203.3          |
| Annuity and supplemental insurance acquisition expenses | 40.0                                       | 38.2         | 125.2                                     | 102.0          |
| Interest charges on borrowed money                      | 17.8                                       | 18.3         | 53.6                                      | 53.9           |
| Other operating and general expenses                    | <u>115.9</u>                               | <u>115.1</u> | <u>408.5</u>                              | <u>337.0</u>   |
|   | <u>1,011.0</u>                             | <u>979.2</u> | <u>2,875.1</u>                            | <u>2,653.9</u> |
| Operating earnings before income taxes                  | 183.8                                      | 157.3        | 491.2                                     | 473.7          |
| Provision for income taxes                              | <u>62.9</u>                                | <u>56.5</u>  | <u>172.0</u>                              | <u>157.8</u>   |
| Net operating earnings                                  | 120.9                                      | 100.8        | 319.2                                     | 315.9          |
| Minority interest expense                               | (7.8)                                      | (6.7)        | (26.4)                                    | (21.7)         |



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|   | <u>Common<br/>Shares</u> | <u>and Capital<br/>Surplus</u> | <u>Retained<br/>Earnings</u> | <u>Comprehensive<br/>Income (Loss)</u> | <u>Total</u>     |
|---|--------------------------|--------------------------------|------------------------------|--|------------------|
| Balance at December 31, 2006                                      | 119,303,928              | \$1,339.8                      | \$1,533.6                    | \$ 55.5                                | \$2,928.9        |
| Cumulative effect of accounting change                            | -                        | -                              | (14.9)                       | -                                      | (14.9)           |
| Net earnings  | -                        | -                              | 293.3                        | -                                      | 293.3            |
| Other comprehensive income, net of tax:                           |                          |                                |                              |  |                  |
| Change in unrealized gain (loss)<br>on securities                 | -                        | -                              | -                            | (71.1)                                 | (71.1)           |
| Change in foreign currency translation                            | -                        | -                              | -                            | 20.6                                   | 20.6             |
| Change in unrealized pension and other<br>postretirement benefits | -                        | -                              | -                            | 2.9                                    | <u>2.9</u>       |
| <br>Total comprehensive income                                    |                          |                                |                              |  | <br>245.7        |
| Dividends on Common Stock   | -                        | -                              | (35.8)                       | -                                      | (35.8)           |
| Shares issued:  |                          |                                |                              |  |                  |
| Exercise of stock options   | 641,460                  | 14.9                           | -                            | -                                      | 14.9             |
| Dividend reinvestment plan  | 126,523                  | 4.0                            | -                            | -                                      | 4.0              |
| Employee stock purchase plan                                      | 29,112                   | 1.0                            | -                            | -                                      | 1.0              |
| Deferred compensation distributions                               | 31,863                   | 1.1                            | -                            | -                                      | 1.1              |
| Directors fees paid in stock                                      | 9,965                    | .4                             | -                            | -                                      | .4               |
| Stock incentive plan  | 114,594                  | 3.9                            | -                            | -                                      | 3.9              |
| Other stock-based compensation expense                            | -                        | 7.1                            | -                            | -                                      | 7.1              |
| Shares acquired and retired                                       | (4,700,139)              | (53.2)                         | (80.2)                       | -                                      | (133.4)          |
| Shares tendered in option exercises                               | (26,498)                 | (.3)                           | (.6)                         | -                                      | (.9)             |
| Effect of minority interest repurchased                           | -                        | -                              | -                            | (8.0)                                  | (8.0)            |
| Capital transactions of subsidiaries                              | <u>-</u>                 | <u>(1.1)</u>                   | <u>-</u>                     | <u>-</u>                               | <u>(1.1)</u>     |
|   | )                        |                                |                              | )                                      |                  |
| Balance at September 30, 2007                                     | <u>115,530,808</u>       | <u>\$1,317.6</u>               | <u>1,695.4</u>               | <u>(\$ .1)</u>                         | <u>\$3,012.9</u> |
| <br>Balance at December 31, 2005                                  | 117,101,271              | \$1,272.7                      | \$1,134.1                    | \$ 50.8                                | \$2,457.6        |
| Net earnings  | -                        | -                              | 317.9                        | -                                      | 317.9            |
| Other comprehensive income, net of tax:                           |                          |                                |                              |  |                  |
| Change in unrealized gain on securities                           | -                        | -                              | -                            | (30.7)                                 | <u>(30.7)</u>    |
| <br>Total comprehensive income                                    |                          |                                |                              | )                                      | <br>287.2        |

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|                                      |                    |                  |                  |                |                  |
|--------------------------------------|--------------------|------------------|------------------|----------------|------------------|
| Dividends on Common Stock            | -                  | -                | (32.4)           | -              | (32.4)           |
| Shares issued:                       |                    |                  |                  |                |                  |
| Exercise of stock options            | 1,541,427          | 35.8             | -                | -              | 35.8             |
| Dividend reinvestment plan           | 145,243            | 3.8              | -                | -              | 3.8              |
| Employee stock purchase plan         | 27,206             | .8               | -                | -              | .8               |
| Deferred compensation distributions  | 63,162             | 1.6              | -                | -              | 1.6              |
| Directors fees paid in stock         | 12,780             | .4               | -                | -              | .4               |
| Shares tendered in option exercises  | (217,953)          | (2.4)            | (3.8)            | -              | (6.2)            |
| Stock-based compensation expense     | -                  | 5.1              | -                | -              | 5.1              |
| Capital transactions of subsidiaries | -                  | 1.9              | -                | -              | 1.9              |
| Other                                | <u>-</u>           | <u>4.6</u>       | <u>-</u>         | <u>-</u>       | <u>4.6</u>       |
| Balance at September 30, 2006        | <u>118,673,136</u> | <u>\$1,324.3</u> | <u>\$1,415.8</u> | <u>\$ 20.1</u> | <u>\$2,760.2</u> |

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AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

|  | Nine months ended<br><u>September 30,</u> |             |
|--|---|-------------|
|  | <u>2007</u>                               | <u>2006</u> |
| Operating Activities:                              |   |             |
| Net earnings                                       | \$ 293.3                                  | \$ 317.9    |
| Adjustments:                                       |   |             |
| Equity in net losses of investee                   | 1.2                                       | 1.6         |
| Minority interest                                  | 26.7                                      | 27.5        |
| Depreciation and amortization                      | 139.7                                     | 120.7       |
| Annuity benefits                                   | 273.7                                     | 255.2       |
| Realized gains on investing activities             | (26.9)                                    | (82.8)      |
| Net purchases/sales of trading securities          | (34.8)                                    | (10.8)      |
| Deferred annuity and life policy acquisition costs | (154.6)                                   | (114.6)     |
| Increase in reinsurance and other receivables      | (321.1)                                   | (503.6)     |
| Decrease (increase) in other assets                | (177.9)                                   | 48.8        |
| Increase in insurance claims and reserves          | 483.8                                     | 546.2       |



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|  |             |             |
|--|-------------|-------------|
| Increase in payable to reinsurers        | 96.6        | 181.0       |
| Increase (decrease) in other liabilities | 10.3        | (6.8)       |
| Other, net                               | <u>11.0</u> | <u>17.4</u> |

|   |              |              |
|---|--------------|--------------|
| Net cash provided by operating activities | <u>621.0</u> | <u>797.7</u> |
|---|--------------|--------------|

Investing Activities

:

Purchases of and additional investments in:

|  |           |           |
|--|-----------|-----------|
| Fixed maturity investments                               | (2,894.6) | (1,872.0) |
| Equity securities  | (416.4)   | (264.7)   |
| Subsidiaries   | (239.7)   | (207.0)   |
| Real estate, property and equipment                      | (25.0)    | (36.9)    |
| Maturities and redemptions of fixed maturity investments | 1,125.5   | 708.5     |

Sales of:

|  |         |         |
|--|---------|---------|
| Fixed maturity investments                           | 1,164.1 | 1,176.9 |
| Equity securities                                    | 125.4   | 185.9   |
| Subsidiary   | -       | 37.5    |
| Real estate, property and equipment                  | 24.0    | 36.2    |
| Decrease (increase) in securities lending collateral | 11.2    | (159.2) |

Cash and cash equivalents of businesses  
acquired or sold, net

- 201.9

|                               |                |               |
|-------------------------------|----------------|---------------|
| Increase in other investments | <u>(108.5)</u> | <u>(38.7)</u> |
|-------------------------------|----------------|---------------|

|                                       |                  |                |
|---------------------------------------|------------------|----------------|
| Net cash used in investing activities | <u>(1,234.0)</u> | <u>(231.6)</u> |
|---------------------------------------|------------------|----------------|

Financing Activities

:

|  |            |             |
|--|------------|-------------|
| Annuity receipts                                     | 1,204.5    | 914.3       |
| Annuity surrenders, benefits and withdrawals         | (1,057.3)  | (898.6)     |
| Net transfers from variable annuity assets           | 51.3       | 17.8        |
| Additional long-term borrowings                      | 142.0      | 117.5       |
| Reductions of long-term debt                         | (167.5)    | (207.0)     |
| Increase (decrease) in securities lending obligation | (11.2)     | 159.2       |
| Issuances of Common Stock                            | 14.5       | 27.9        |
| Repurchases of Common Stock                          | (133.4)    | -           |
| Cash dividends paid on Common Stock                  | (31.7)     | (28.6)      |
| Other, net   | <u>2.0</u> | <u>(.6)</u> |

|   |             |              |
|---|-------------|--------------|
| Net cash provided by financing activities | <u>13.2</u> | <u>101.9</u> |
|---|-------------|--------------|

|  |                 |                  |
|--|-----------------|------------------|
| Net Increase (Decrease) in Cash and Cash Equivalents | (599.8)         | 668.0            |
| Cash and cash equivalents at beginning of period     | <u>1,329.0</u>  | <u>471.8</u>     |
| Cash and cash equivalents at end of period           | <u>\$ 729.2</u> | <u>\$1,139.8</u> |

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO NOTES

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| A. <u>Accounting Policies</u>                  | F. <u>Shareholders' Equity</u>                |
| B. <u>Acquisitions and Sales of Operations</u> | G. <u>Income Taxes</u>                        |
| C. <u>Segments of Operations</u>               | H. <u>Discontinued Operations</u>             |
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| E. <u>Long-Term Debt</u>                       | J. <u>Condensed Consolidating Information</u> |

A. Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements for American Financial Group, Inc. ("AFG") and subsidiaries are unaudited; however, management believes that all adjustments (consisting only of normal recurring accruals unless otherwise disclosed herein) necessary for fair presentation have been made. The results of operations for interim periods are not necessarily indicative of results to be expected for the year. The financial statements have been prepared in accordance with the instructions to Form 10-Q and therefore do not include all information and footnotes necessary to be in conformity with U.S. generally accepted accounting principles.

Certain reclassifications have been made to prior years to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. All acquisitions have been treated as purchases. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates.

### Stock Split

All shares and per share amounts (except number of shares authorized and the stated value of \$1.00 per share) presented in the financial statements have been adjusted for all periods presented to reflect the effect of a three-for-two Common Stock split on December 15, 2006.

### Investments

Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in a separate component of shareholders' equity. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in investment income. Loans receivable are carried primarily at the aggregate unpaid balance. Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other than temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains) and the cost basis of that investment is reduced.

Certain AFG subsidiaries loan fixed maturity and equity securities to other institutions for short periods of time. The borrower is required to provide collateral on which AFG earns investment income, net of a fee to the lending

agent. AFG records the collateral held (included in other assets) and the liability to return the collateral (included in other liabilities) in its Balance Sheet at fair value. The securities loaned remain a recorded asset on AFG's Balance Sheet. At September 30, 2007, the fair value of collateral held was approximately \$147 million and the fair value of securities loaned plus accrued interest was approximately \$145 million.

### Derivatives

Derivatives included in AFG's Balance Sheet are recorded at fair value and consist primarily of (i) the interest component of certain life reinsurance contracts (included in other liabilities), (ii) interest rate swaps (included in debt), and (iii) the equity-based component of certain annuity products (included in annuity benefits accumulated) and related call options (included in other investments) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those annuity products. Changes in the fair value of derivatives are included

in current earnings.

The terms of the interest rate swaps match those of the debt; therefore, the swaps are considered to be (and are accounted for as) 100% effective fair value hedges. Both the swaps and the hedged debt are adjusted for changes in fair value by offsetting amounts. Accordingly, since the swaps are included with long-term debt in the Balance Sheet, the only effect on AFG's financial statements is that the interest expense on the hedged debt is recorded based on the variable rate.

### Goodwill

Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually.

### Reinsurance

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG's property and casualty insurance subsidiaries report as assets (a) the estimated reinsurance recoverable on paid and unpaid losses, including an estimate for losses incurred but not reported, and (b) amounts paid to reinsurers applicable to the unexpired terms of policies in force. Payable to reinsurers includes ceded premiums due to reinsurers as well as ceded premiums retained by AFG's property and casualty insurance subsidiaries under contracts to fund ceded losses as they become due. AFG's insurance subsidiaries also assume reinsurance from other companies. Income on reinsurance assumed is recognized based on reports received from ceding companies.

Certain annuity and supplemental insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby the subsidiaries retain the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be adjusted to fair value) because the yield on the payables is based on specific blocks of the ceding companies' assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to these transactions are classified as "trading." The adjustment to fair value on the embedded derivatives offsets the investment income recorded on the adjustment to fair value of the related trading portfolios.

### Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses, unamortized acquisition costs and

policy maintenance costs exceed the related unearned premiums. A premium deficiency would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency was greater than unamortized acquisition costs, a liability would be accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

DPAC related to annuities and universal life insurance products is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of actual and expected gross profits on the policies. To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains. DPAC related to annuities is also adjusted, net of tax, for the change in amortization that would have been recorded if the unrealized gains (losses) from securities had actually been realized. This adjustment is included in unrealized gains on marketable securities, a component of "Accumulated Other Comprehensive Income (Loss), net of tax" in the shareholders' equity section of the Balance Sheet.

DPAC related to traditional life and health insurance is amortized over the expected premium paying period of the related policies, in proportion to the ratio of annual premium revenues to total anticipated premium revenues. DPAC includes the present value of future profits on business in force of insurance companies acquired by AFG's annuity and supplemental insurance business, which represents the portion of the costs to acquire companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition. The present value of future profits is amortized with interest in relation to expected gross profits of the acquired policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

#### Unpaid Losses and Loss Adjustment Expenses

The net liabilities stated for unpaid claims and for expenses of investigation and adjustment of unpaid claims are based upon (a) the accumulation of case estimates for losses reported prior to the close of the accounting period on direct business written; (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of unreported losses (including possible development on known claims) based on past experience; (d) estimates based on experience of expenses for investigating and adjusting claims; and (e) the current state of the law and coverage litigation. Establishing reserves for asbestos, environmental and other mass tort claims involves considerably more judgment than other types of claims due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage.

Loss reserve liabilities are subject to the impact of changes in claim amounts and frequency and other factors. Changes in estimates of the liabilities for losses and loss adjustment expenses are reflected in the Statement of Earnings in the period in which determined. Despite the variability inherent in such

estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

### **Annuity Benefits Accumulated**

Annuity receipts and benefit payments are recorded as increases or decreases in "annuity benefits accumulated" rather than as revenue and expense. Increases in this liability for interest credited are charged to expense and decreases for surrender charges are credited to other income.

### **Life, Accident and Health Reserves**

Liabilities for future policy benefits under traditional life, accident and health policies are computed using the net level premium method. Computations are based on the original projections of investment yields, mortality, morbidity and surrenders and include provisions for unfavorable deviations. Reserves established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

### **Variable Annuity Assets and Liabilities**

Separate accounts related to variable annuities represent the fair value of deposits invested in underlying investment funds on which AFG earns a fee. Investment funds are selected and may be changed only by the policyholder, who retains all investment risk.

### **Premium Recognition**

Property and casualty premiums are earned generally over the terms of the policies on a pro rata basis. Unearned premiums represent that portion of premiums written which is applicable to the unexpired terms of policies in force. On reinsurance assumed from other insurance companies or written through various underwriting organizations, unearned premiums are based on reports received from such companies and organizations. For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. For interest-sensitive life and universal life products, premiums are recorded in a policyholder account, which is reflected as a liability. Revenue is recognized as amounts are assessed against the policyholder account for mortality coverage and contract expenses.

### **Minority Interest**

For Balance Sheet purposes, minority interest represents the interests of noncontrolling shareholders in consolidated entities. In the Statement of Earnings, minority interest expense represents such shareholders' interest in the earnings of those entities.

### **Income Taxes**

AFG files consolidated federal income tax returns that include all U.S. subsidiaries that are at least 80%-owned, except for certain life insurance subsidiaries that have been owned for less than five years.

Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on

differences between financial reporting and tax bases and are measured using enacted tax rates. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

AFG records a liability for the inherent uncertainty in quantifying its income tax provisions. Interest and penalties related to these unrecognized tax benefits are recognized as a component of tax expense.

AFG implemented FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" ("FIN 48") on January 1, 2007. FIN 48 sets forth criteria for recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 requires that companies recognize the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

the position. FIN 48 also provides guidance on derecognition, classification, interest, penalties, accounting in interim periods and disclosure. The cumulative effect of applying FIN 48 was recorded as a reduction to retained earnings at January 1, 2007 and is shown separately in the Statement of Changes in Shareholders' Equity. See *Note G - "Income Taxes."*

Stock-Based Compensation

All share-based grants are recognized as compensation expense over their vesting periods based on their calculated "fair value" at the date of grant. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options. See *Note F - "Shareholders' Equity"* for further information on stock options.

Benefit Plans

AFG provides retirement benefits to qualified employees of participating companies through the AFG Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Company contributions are expensed in the year for which they are declared.

AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period employees earn such benefits.

Earnings Per Share

Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes (in millions):

| <u>Three months ended</u> |             | <u>Nine months ended</u> |             |
|---------------------------|-------------|--------------------------|-------------|
| <u>September 30,</u>      |             | <u>September 30,</u>     |             |
| <u>2007</u>               | <u>2006</u> | <u>2007</u>              | <u>2006</u> |

Adjustments to net earnings:

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|  |         |         |         |         |
|--|---------|---------|---------|---------|
| Dilution of majority-owned subsidiaries                        | (\$0.1) | (\$0.4) | (\$1.0) | (\$0.9) |
| Assumed issuance of shares under<br>deferred compensation plan | (0.6)   | -       | (0.8)   | -       |
| Adjustments to weighted average common shares:                 |         |         |         |         |
| Stock-based compensation plans                                 | 2.3     | 2.5     | 2.7     | 2.3     |

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: third quarter of 2007 and 2006 - 2.5 million and 1.8 million; nine months of 2007 and 2006 - 1.1 million and 1.6 million.

Statement of Cash Flows

For cash flow purposes, "investing activities" are defined as making and collecting loans and acquiring and disposing of debt or equity instruments and property and equipment. "Financing activities" include obtaining resources from owners and providing them with a return on their investments, borrowing money and repaying amounts borrowed. Annuity receipts, benefits and withdrawals are also reflected as financing activities. All other activities are considered "operating." Short-term investments having original maturities of three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

B.

**Acquisitions and Sales of Operations**

**Great American Financial Resources**

On September 28, 2007, Great American Financial Resources, Inc. ("GAFRI") completed the acquisition of the remaining 9.2 million shares (19%) of its common stock not previously owned by AFG at a price of \$24.50 per share in cash. Total cost of the acquisition, including cash paid for vested options and merger costs, was \$238 million. Based on the preliminary allocation of purchase price, the merger resulted in a \$217 million reduction of minority interest and an increase of \$21 million in goodwill.

**Ceres Group, Inc.**

In August 2006, GAFRI acquired Ceres Group, Inc. ("Ceres") for \$204.4 million in cash (plus approximately \$8 million in direct transaction costs). In connection with the acquisition, Ceres reinsured 100% of its major medical business and 50% of its in-force senior business, which focuses primarily on sales of Medicare supplement and other supplemental insurance products to the senior market. As a result of the reinsurance, Ceres has exited the major medical business. Following the acquisition, Ceres paid a \$60 million return of capital distribution to GAFRI. During 2007, goodwill related to Ceres increased by \$16.1 million due to a refinement of the purchase price allocation.

**Chatham Bars Inn**



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In June 2006, GAFRI sold a resort hotel located on Cape Cod for \$166 million. See *Note H - "Discontinued Operations."*

### Old Standard Life Fixed Annuity Business

In January 2006, GAFRI acquired the fixed annuity business written by Old Standard Life Insurance Company through a reinsurance transaction. As part of the assets transferred in the reinsurance transaction, GAFRI acquired the stock of Old West Annuity and Life Insurance Company. In total, the transaction resulted in an increase of approximately \$280 million in both annuity benefits accumulated and cash and investments.

### Great American Life Assurance Company of Puerto Rico

GAFRI completed the sale of its subsidiary, Great American Life Assurance Company of Puerto Rico ("GAPR"), for \$37.5 million in cash in January 2006. GAFRI acquired GAPR in 1997 for approximately \$50 million. During 2005, GAFRI received \$100 million in dividends from GAPR and recorded a \$3.4 million loss on the anticipated sale.

C.

**Segments of Operations** AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity and supplemental insurance and (iii) other, which includes holding company costs.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive and professional liability and customized programs for small to mid-sized businesses, (iii) Specialty financial, which includes risk management insurance programs for lending and leasing institutions, surety and fidelity products and trade credit insurance, and (iv) California workers' compensation. AFG's annuity and supplemental insurance business markets traditional fixed, indexed and variable annuities and a variety of supplemental insurance products. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

The following tables (in millions) show AFG's revenues and operating earnings before income taxes by significant business segment and sub-segment.

| Three months ended   |             | Nine months ended    |             |
|----------------------|-------------|----------------------|-------------|
| <u>September 30,</u> |             | <u>September 30,</u> |             |
| <u>2007</u>          | <u>2006</u> | <u>2007</u>          | <u>2006</u> |

Revenues

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Property and casualty insurance:

Premiums earned:

Specialty

|                                  |             |             |              |              |
|----------------------------------|-------------|-------------|--------------|--------------|
| Property and transportation      | \$ 350.1    | \$ 322.4    | \$ 817.5     | \$ 747.5     |
| Specialty casualty               | 206.6       | 207.6       | 630.0        | 593.1        |
| Specialty financial              | 125.1       | 110.6       | 351.9        | 304.2        |
| California workers' compensation | 57.1        | 69.6        | 178.6        | 222.8        |
| Other                            | 18.4        | 20.3        | 52.3         | 55.9         |
| Other lines                      | <u>.2</u>   | <u>.4</u>   | <u>.5</u>    | <u>1.5</u>   |
|                                  | 757.5       | 730.9       | 2,030.8      | 1,925.0      |
| Investment income                | 89.6        | 79.8        | 260.3        | 240.5        |
| Realized gains (losses)          | (4.6)       | 1.4         | 5.1          | 28.7         |
| Other                            | <u>50.3</u> | <u>45.9</u> | <u>149.6</u> | <u>143.8</u> |
|                                  | 892.8       | 858.0       | 2,445.8      | 2,338.0      |

Annuity and supplemental insurance:

|                                    |             |             |             |             |
|------------------------------------|-------------|-------------|-------------|-------------|
| Investment income                  | 161.2       | 151.7       | 479.5       | 452.4       |
| Life, accident and health premiums | 105.6       | 91.7        | 315.6       | 249.3       |
| Realized gains (losses)            | (6.2)       | (2.8)       | 3.8         | (7.9)       |
| Other                              | <u>33.1</u> | <u>33.0</u> | <u>92.0</u> | <u>79.3</u> |
|                                    | 293.7       | 273.6       | 890.9       | 773.1       |
| Other                              | <u>8.3</u>  | <u>4.9</u>  | <u>29.6</u> | <u>16.5</u> |

\$1,194.8      \$1,136.5      \$3,366.3      \$3,127.6

Operating Earnings Before Income Taxes

Property and casualty insurance:

Underwriting:

Specialty

|                             |         |         |          |          |
|-----------------------------|---------|---------|----------|----------|
| Property and transportation | \$ 58.5 | \$ 40.4 | \$ 123.2 | \$ 113.6 |
|-----------------------------|---------|---------|----------|----------|

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|  |                 |                 |                 |                 |
|--|-----------------|-----------------|-----------------|-----------------|
| Specialty casualty                             | 39.0            | 44.0            | 165.3           | 87.0            |
| Specialty financial                            | 8.2             | (24.1)          | 22.5            | (22.7)          |
| California workers' compensation               | 12.8            | 25.3            | 37.9            | 54.1            |
| Other (a)                                      | (13.7)          | (3.4)           | (26.1)          | (3.1)           |
| Other lines (b)                                | <u>(3.0)</u>    | <u>(1.4)</u>    | <u>(48.1)</u>   | <u>(6.4)</u>    |
|  | )               | )               | )               | )               |
|  | 101.8           | 80.8            | 274.7           | 222.5           |
| Investment income, realized gains<br>and other | <u>74.7</u>     | <u>70.9</u>     | <u>231.5</u>    | <u>244.0</u>    |
|  | 176.5           | 151.7           | 506.2           | 466.5           |
| Annuity and supplemental insurance             | 23.3            | 30.8            | 89.4            | 78.9            |
| Other (c)                                      | <u>(16.0)</u>   | <u>(25.2)</u>   | <u>(104.4)</u>  | <u>(71.7)</u>   |
|  | )               | )               | )               | )               |
|  | <u>\$ 183.8</u> | <u>\$ 157.3</u> | <u>\$ 491.2</u> | <u>\$ 473.7</u> |

- (a) Includes charges of \$11.3 million in the third quarter of 2007 and \$24.8 million for the first nine months of 2007 to adjust a retroactive reinsurance gain.
- (b) Includes a second quarter 2007 charge of \$44.2 million to increase asbestos and environmental reserves.
- (c) Includes holding company expenses and a second quarter 2007 charge of \$41 million related to asbestos and environmental liabilities at former railroad and manufacturing operations.

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**Deferred Policy Acquisition Costs** As discussed in Note A - "Accounting Policies," deferred policy acquisition costs related to annuities are adjusted for changes in unrealized gains (losses) on securities.

Included in deferred policy acquisition costs in AFG's Balance Sheet are \$73.5 million and \$95.0 million at September 30, 2007, and December 31, 2006, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity and supplemental insurance business. In the second quarter of 2007, PVFP was reduced by \$12.3 million due to a refinement of the purchase price allocation for the August 2006 Ceres acquisition. The PVFP amounts are net of \$80.0 million and \$70.5 million of accumulated amortization. Amortization of the PVFP was \$1.9 million in the third quarter and \$9.5 million during the first nine months of 2007 and \$2.8 million in the third quarter and \$6.1 million in the first nine months of 2006, respectively. The increase in amortization for the first nine months of 2007 compared to the 2006 period reflects the acquisition of Ceres.

E.

**Long-Term Debt** The carrying value of long-term debt consisted of the following (in millions):

|  | September 30,<br><u>2007</u> | December 31,<br><u>2006</u> |
|--|------------------------------|-----------------------------|
| Direct obligations of AFG:   |                              |                             |
| 7-1/8% Senior Debentures due April 2009                                  | \$173.1                      | \$182.9                     |
| Senior Convertible Notes due June 2033                                   | 189.7                        | 189.7                       |
| 7-1/8% Senior Debentures due February 2034                               | 115.0                        | 115.0                       |
| 7-1/8% Senior Debentures due December 2007                               | 59.5                         | 59.5                        |
| Other  | <u>3.7</u>                   | <u>3.8</u>                  |
|  | <u>541.0</u>                 | <u>550.9</u>                |
| Subsidiaries   |                              |                             |
| :  |                              |                             |
| Obligations of AAG Holding (guaranteed by AFG):                          |                              |                             |
| 7-1/2% Senior Debentures due November 2033                               | 112.5                        | 112.5                       |
| 7-1/4% Senior Debentures due January 2034                                | 86.3                         | 86.3                        |
| 6-7/8% Senior Notes due June 2008  | 28.5                         | 31.5                        |
| Borrowings under bank credit facility                                    | 16.0                         | -                           |
| Notes payable secured by real estate                                     | 67.6                         | 67.8                        |
| American Premier Underwriters 10-7/8% Subordinated<br>Notes due May 2011 | 8.0                          | 8.1                         |
| Other  | <u>2.3</u>                   | <u>6.9</u>                  |
|  | <u>321.2</u>                 | <u>313.1</u>                |
| Payable to Subsidiary Trusts:  |                              |                             |
| AAG Holding 7.35% Subordinated Debentures due<br>May 2033                | 20.0                         | 20.0                        |
| AAG Holding 8-7/8% Subordinated Debentures                               | -                            | 22.0                        |

|   |                |                |
|---|----------------|----------------|
| National Interstate Variable Rate Subordinated<br>Debentures due May 2033 | <u>15.0</u>    | <u>15.0</u>    |
|   | <u>35.0</u>    | <u>57.0</u>    |
|   | <u>\$897.2</u> | <u>\$921.0</u> |

At September 30, 2007, scheduled principal payments on debt for the balance of 2007 and the subsequent five years were as follows: 2007 - \$60.4 million; 2008 - \$29.2 million; 2009 - \$174.6 million; 2010 - \$2.8 million; 2011 - \$25.1 million; and 2012 - \$1.4 million.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

As shown below (in millions), the majority of AFG's long-term debt is unsecured obligations of the holding company and its subsidiaries:

|                                    | September 30,<br><u>2007</u> | December 31,<br><u>2006</u> |
|------------------------------------|------------------------------|-----------------------------|
| Unsecured obligations              | \$829.6<br><u>67.6</u>       | \$853.2<br><u>67.8</u>      |
| Obligations secured by real estate | <u>\$897.2</u>               | <u>\$921.0</u>              |

On March 1, 2007, GAFRI's wholly-owned subsidiary, AAG Holding, used funds borrowed under the bank credit facility to redeem its \$22 million in outstanding 8-7/8% Subordinated Debentures for \$22.9 million.

In March 2006, AFG and AAG Holding replaced their existing credit agreements with a five-year revolving credit facility under which they can borrow a combined \$500 million. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. At September 30, 2007, AAG Holding had \$16 million in borrowings outstanding under the credit facility (interest rate of 6.3% at September 30, 2007).

To achieve a desired balance between fixed and variable rate debt, AAG Holding has entered into interest rate swaps that effectively convert its 6-7/8% fixed rate Senior Notes to a floating rate of 3-month LIBOR plus 2.9%.

AFG's Senior Convertible Notes were issued at a price of 37.153% of the principal amount due at maturity. Interest is payable semiannually at a rate of 4% of issue price per year through June 2008, after which interest at 4% annually will be accrued and added to the carrying value of the Notes. The Notes are redeemable at AFG's option at any time on or after June 2, 2008, at accreted value ranging from \$371.53 per Note to \$1,000 per Note at maturity. Generally, holders may convert each Note into 17.2524 shares of AFG Common Stock (at \$21.53 per share currently) (i) if the average market price of AFG Common Stock to be received upon conversion exceeds 120% of the accreted value (\$25.84 per share currently) for a specified period, (ii) if the credit rating of the Notes is significantly lowered, or, (iii) if AFG calls the notes for redemption. Based on the market price of AFG's Common Stock during the quarter ended September 30, 2007, the Notes are currently convertible through December 31, 2007. AFG has delivered cash in lieu of Common Stock upon conversion of the Notes and intends to continue to do so. Accordingly, shares issuable upon conversion of the Notes are not included in AFG's calculation of diluted earnings per share.

**F. Shareholders' Equity** In December 2006, AFG completed a three-for-two common stock split. See "Stock Split" in Note A - "Accounting Policies." AFG is authorized to issue 12.5 million shares of Voting Preferred Stock and 12.5 million shares of Nonvoting Preferred Stock, each without par value.

During the first nine months of 2007, AFG repurchased 4.7 million shares of its Common Stock for approximately \$133 million.

Accumulated Other Comprehensive Income (Loss), Net of Tax

The components of accumulated other comprehensive income (loss) were as follows (in millions):

|  | September 30,<br><u>2007</u> | December 31,<br><u>2006</u> |
|--|------------------------------|-----------------------------|
| Net unrealized gain (loss) on securities             | (\$29.1)                     | \$50.7                      |
| Foreign currency translation adjustment              | 24.9                         | 4.3                         |
|  | <u>4.1</u>                   | <u>.5</u>                   |
| Unrealized pension and other postretirement benefits | (\$ .1)                      | <u>\$55.5</u>               |
| Total accumulated other comprehensive income (loss)  |                              |                             |

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Under AFG's Stock Incentive Plan, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. In the first nine months of 2007, AFG issued 114,594 shares of Common Stock and granted stock options for 1.7 million shares of Common Stock (at an average strike price of \$34.33) under the Stock Incentive Plan.

AFG uses the Black-Scholes option pricing model to calculate the "fair value" of its option grants. Expected volatility is based on historical volatility (after consideration of other factors). The weighted average fair value of options granted during 2007 was \$9.73 per share based on the following assumptions: expected dividend yield - 1.3%; expected volatility - 22%; expected term - 6 1/2 years; risk-free rate - 4.6%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was as follows: third quarter of 2007 and 2006 - \$2.5 million and \$2.6 million; nine months of 2007 and 2006 - \$13.2 million and \$7.4 million, respectively. Stock-based compensation expense for the first nine months of 2007 includes \$3.9 million in first quarter non-deductible stock awards.

G.

**Income Taxes** AFG increased its liability for unrecognized tax benefits and reduced retained earnings by \$14.9 million for the cumulative effect of implementing the provisions of FIN 48 on January 1, 2007. Total unrecognized income tax benefits at January 1, 2007, were \$47.5 million, including \$9.5 million for interest and municipal penalties. Included in this balance are \$43.4 million of unrecognized benefits that, if recognized, would reduce AFG's effective tax rate. Other than the municipal settlement discussed below, these amounts did not change materially as of September 30, 2007, and no significant changes to the liability are anticipated within the next 12 months.

As of January 1, 2007, AFG's 2004, 2005 and 2006 tax years remain subject to examination by the IRS. In addition, AFG has several tax years for which there are ongoing disputes. AFG has subsidiaries in various states, cities and provinces that are currently under audit for years ranging from 1995 through 2004. In April 2007, AFG signed a settlement agreement with a municipality. As a result of this settlement, AFG reduced its liability for unrecognized income tax benefits by \$5.7 million (\$3.7 million net of federal tax effect) in the second quarter of 2007.

H.

**Discontinued Operations** In the second quarter of 2006, GAFRI sold Chatham Bars Inn, its resort-hotel property located on Cape Cod for \$166 million. The results of operations of this investment property and the \$25.8 million gain on sale (after tax and minority interest) are presented as discontinued operations in the Statement of Earnings. Discontinued operations for 2007 represent additional gains on operations sold in previous years, primarily the settlement of a contingency associated with the Chatham sale.

**Commitments and Contingencies** Except as discussed in *Management's Discussion and Analysis - "Asbestos and Environmental Reserve Charge,"* there have been no significant changes to the matters discussed and referred to in Note M - "Commitments and Contingencies" of AFG's 2006 Annual Report on Form 10-K.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**Gondensed Consolidating Information** In connection with GAFRI's acquisition of its publicly held common stock in September 2007, AFG has guaranteed all of the outstanding debt of GAFRI and GAFRI's wholly-owned subsidiary, AAG Holding Company, Inc. In addition, GAFRI guarantees AAG Holding's public debt. The AFG and GAFRI guarantees are full and unconditional and joint and

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several. Condensed consolidating financial statements for AFG are as follows:

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

| <u>September 30, 2007</u>  | <u>AFG</u>       | <u>GAFRI</u>     | <u>AAG<br/>Holding</u> | <u>All Other<br/>Subs</u> | <u>Cons<br/>Entries</u> | <u>Consolidated</u> |
|--|------------------|------------------|------------------------|---------------------------|-------------------------|---------------------|
| <b>Assets:</b>   |                  |                  |                        |                           |                         |                     |
| Cash and investments   | \$ 51.4          | \$ 23.0          | \$ .4                  | \$17,980.1                | (\$ 1.8)                | \$18,053.1          |
| Recoverables from reinsurers and<br>prepaid reinsurance premiums | -                | -                | -                      | 3,703.5                   | -                       | 3,703.5             |
| Agents' balances and premiums<br>receivable                      | -                | -                | -                      | 811.6                     | -                       | 811.6               |
| Deferred policy acquisition costs                                | -                | -                | -                      | 1,382.9                   | -                       | 1,382.9             |
| Other assets   | 12.6             | 21.9             | 6.7                    | 2,108.1                   | 15.5                    | 2,164.8             |
| Investment in subsidiaries and<br>affiliates                     | <u>3,696.4</u>   | <u>1,108.0</u>   | <u>1,235.4</u>         | <u>1,868.8</u>            | <u>(7,908.6)</u>        | <u>-</u>            |
|  |                  |                  |                        | )                         |                         |                     |
|  | <u>\$3,760.4</u> | <u>\$1,152.9</u> | <u>\$1,242.5</u>       | <u>\$27,855.0</u>         | <u>(\$7,894.9)</u>      | <u>\$26,115.9</u>   |
| <b>Liabilities and Capital:</b>                                  |                  |                  |                        |                           |                         |                     |
| Unpaid losses, loss adjustment expenses<br>and unearned premiums | \$ -             | \$ -             | \$ -                   | \$ 8,108.8                | \$ -                    | \$ 8,108.8          |
| Annuity, life, accident and health<br>benefits and reserves      | -                | -                | -                      | 11,456.1                  | (5.4)                   | 11,450.7            |
| Long-term debt   | 541.0            | .8               | 335.4                  | 91.9                      | (71.9)                  | 897.2               |
| Other liabilities  | <u>206.5</u>     | <u>316.3</u>     | <u>110.8</u>           | <u>2,284.2</u>            | <u>(271.5)</u>          | <u>2,646.3</u>      |
|  |                  |                  |                        | )                         |                         |                     |
|  | 747.5            | 317.1            | 446.2                  | 21,941.0                  | (348.8)                 | 23,103.0            |
| Total shareholders' equity                                       | <u>3,012.9</u>   | <u>835.8</u>     | <u>796.3</u>           | <u>5,914.0</u>            | <u>(7,546.1)</u>        | <u>3,012.9</u>      |
|  |                  |                  |                        | )                         |                         |                     |
|  | <u>\$3,760.4</u> | <u>\$1,152.9</u> | <u>\$1,242.5</u>       | <u>\$27,855.0</u>         | <u>(\$7,894.9)</u>      | <u>\$26,115.9</u>   |



December 31, 2006

## Assets:

|  |                  |                  |                  |                   |                    |                   |
|--|------------------|------------------|------------------|-------------------|--------------------|-------------------|
| Cash and investments   | \$ 223.6         | \$ 16.9          | \$ -             | \$17,501.8        | (\$ 3.3)           | \$17,739.0        |
| Recoverables from reinsurers and<br>prepaid reinsurance premiums | -                | -                | -                | 3,625.2           | -                  | 3,625.2           |
| Agents' balances and premiums<br>receivable                      | -                | -                | -                | 599.4             | -                  | 599.4             |
| Deferred policy acquisition costs                                | -                | -                | -                | 1,266.9           | -                  | 1,266.9           |
| Other assets   | 12.7             | 24.7             | 5.8              | 1,777.1           | 50.3               | 1,870.6           |
| Investment in subsidiaries and<br>affiliates                     | <u>3,412.0</u>   | <u>1,113.3</u>   | <u>1,256.8</u>   | <u>1,824.4</u>    | <u>(7,606.5)</u>   | <u>-</u>          |
|  |                  |                  |                  | )                 |                    |                   |
|  | <u>\$3,648.3</u> | <u>\$1,154.9</u> | <u>\$1,262.6</u> | <u>\$26,594.8</u> | <u>(\$7,559.5)</u> | <u>\$25,101.1</u> |

## Liabilities and Capital:

|  |                  |                  |                  |                   |                    |                   |
|--|------------------|------------------|------------------|-------------------|--------------------|-------------------|
| Unpaid losses, loss adjustment expenses<br>and unearned premiums | \$ -             | \$ -             | \$ -             | \$ 7,681.6        | \$ -               | \$ 7,681.6        |
| Annuity, life, accident and health<br>benefits and reserves      | -                | -                | -                | 10,876.5          | (5.1)              | 10,871.4          |
| Long-term debt   | 550.9            | .8               | 396.8            | 96.8              | (124.3)            | 921.0             |
| Other liabilities  | <u>168.5</u>     | <u>80.1</u>      | <u>112.8</u>     | <u>2,115.6</u>    | <u>221.2</u>       | <u>2,698.2</u>    |
|  | 719.4            | 80.9             | 509.6            | 20,770.5          | 91.8               | 22,172.2          |
| Total shareholders' equity                                       | <u>2,928.9</u>   | <u>1,074.0</u>   | <u>753.0</u>     | <u>5,824.3</u>    | <u>(7,651.3)</u>   | <u>2,928.9</u>    |
|  |                  |                  |                  | )                 |                    |                   |
|  | <u>\$3,648.3</u> | <u>\$1,154.9</u> | <u>\$1,262.6</u> | <u>\$26,594.8</u> | <u>(\$7,559.5)</u> | <u>\$25,101.1</u> |

## CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

| FOR THE THREE MONTHS ENDED<br>SEPTEMBER 30, 2007 | <u>AFG</u>     | <u>GAFRI</u>  | <u>AAG<br/>Holding</u> | <u>All Other<br/>Subs</u> | <u>Cons<br/>Entries</u> | <u>Consolidated</u> |
|--|----------------|---------------|------------------------|---------------------------|-------------------------|---------------------|
| Income   |                |               |                        |                           |                         |                     |
| :  |                |               |                        |                           |                         |                     |
| Property and casualty insurance premiums         | \$ -           | \$ -          | \$ -                   | \$ 757.5                  | \$ -                    | \$ 757.5            |
| Life, accident and health premiums               | -              | -             | -                      | 105.6                     | -                       | 105.6               |
| Realized gains (losses)                          | 3.7            | (.2)          | -                      | (11.8)                    | 1.2                     | (7.1)               |
| Investment and other income                      | 1.8            | 3.9           | -                      | 349.2                     | (16.1)                  | 338.8               |
| Equity in earnings of subsidiaries               | <u>194.9</u>   | <u>21.9</u>   | <u>26.2</u>            | <u>10.0</u>               | <u>(253.0)</u>          | <u>-</u>            |
|  | 200.4          | 25.6          | 26.2                   | 1,210.5                   | (267.9)                 | 1,194.8             |
| Costs and Expenses:                              |                |               |                        |                           |                         |                     |
| Insurance benefits and expenses                  | -              | -             | -                      | 877.3                     | -                       | 877.3               |
| Interest charges on borrowed money               | 19.2           | .2            | 8.8                    | 4.1                       | (14.5)                  | 17.8                |
| Other expenses                                   | <u>5.8</u>     | <u>2.8</u>    | <u>1.1</u>             | <u>112.7</u>              | <u>1.9</u>              | <u>124.3</u>        |
|  | <u>25.0</u>    | <u>3.0</u>    | <u>9.9</u>             | <u>994.1</u>              | <u>(12.6)</u>           | <u>1,019.4</u>      |
| Earnings before income taxes                     | 175.4          | 22.6          | 16.3                   | 216.4                     | (255.3)                 | 175.4               |
| Provision for income taxes                       | <u>62.7</u>    | <u>6.1</u>    | <u>1.8</u>             | <u>66.3</u>               | <u>(74.2)</u>           | <u>62.7</u>         |
| Net Earnings                                     | <u>\$112.7</u> | <u>\$16.5</u> | <u>\$ 14.5</u>         | <u>\$ 150.1</u>           | <u>(\$181.1)</u>        | <u>\$ 112.7</u>     |

FOR THE NINE MONTHS ENDED  
SEPTEMBER 30, 2007

## Income

:

|  |                |               |                |                 |                  |                 |
|--|----------------|---------------|----------------|-----------------|------------------|-----------------|
| Property and casualty insurance premiums | \$ -           | \$ -          | \$ -           | \$2,030.8       | \$ -             | \$2,030.8       |
| Life, accident and health premiums       | -              | -             | -              | 315.6           | -                | 315.6           |
| Realized gains (losses)                  | 2.6            | (.3)          | -              | 5.4             | 3.9              | 11.6            |
| Investment and other income              | 7.2            | 14.0          | (3.4)          | 1,034.3         | (43.8)           | 1,008.3         |
| Equity in earnings of subsidiaries       | <u>540.0</u>   | <u>83.0</u>   | <u>106.9</u>   | <u>36.8</u>     | <u>(766.7)</u>   | <u>-</u>        |
|  |                |               |                | )               |                  |                 |
|  | 549.8          | 96.7          | 103.5          | 3,422.9         | (806.6)          | 3,366.3         |
| Costs and Expenses:                      |                |               |                |                 |                  |                 |
| Insurance benefits and expenses          | -              | -             | -              | 2,413.0         | -                | 2,413.0         |
| Interest charges on borrowed money       | 56.9           | .3            | 27.6           | 12.0            | (43.2)           | 53.6            |
| Other expenses                           | <u>30.0</u>    | <u>9.4</u>    | <u>2.9</u>     | <u>385.5</u>    | <u>9.0</u>       | <u>436.8</u>    |
|  | <u>86.9</u>    | <u>9.7</u>    | <u>30.5</u>    | <u>2,810.5</u>  | <u>(34.2)</u>    | <u>2,903.4</u>  |
|  |                |               |                | )               |                  |                 |
| Earnings before income taxes             | 462.9          | 87.0          | 73.0           | 612.4           | (772.4)          | 462.9           |
| Provision for income taxes               | <u>171.3</u>   | <u>27.6</u>   | <u>21.1</u>    | <u>196.7</u>    | <u>(245.4)</u>   | <u>171.3</u>    |
|  |                |               |                | )               |                  |                 |
| Income from continuing operations        | 291.6          | 59.4          | 51.9           | 415.7           | (527.0)          | 291.6           |
| Discontinued operations, net of tax      | <u>1.7</u>     | <u>1.9</u>    | <u>-</u>       | <u>1.9</u>      | <u>(3.8)</u>     | <u>1.7</u>      |
|  |                |               |                | )               |                  |                 |
| Net Earnings                             | <u>\$293.3</u> | <u>\$61.3</u> | <u>\$ 51.9</u> | <u>\$ 417.6</u> | <u>(\$530.8)</u> | <u>\$ 293.3</u> |

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

## CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

| FOR THE THREE MONTHS ENDED<br><u>SEPTEMBER 30, 2006</u> | <u>AFG</u>   | <u>GAFRI</u> | <u>AAG<br/>Holding</u> | <u>All Other<br/>Subs</u> | <u>Cons<br/>Entries</u> | <u>Consolidated</u> |
|---|--------------|--------------|------------------------|---------------------------|-------------------------|---------------------|
| Income  |              |              |                        |                           |                         |                     |
| :   |              |              |                        |                           |                         |                     |
| Property and casualty insurance premiums                | \$ -         | \$ -         | \$ -                   | \$ 730.9                  | \$ -                    | \$ 730.9            |
| Life, accident and health premiums                      | -            | -            | -                      | 91.7                      | -                       | 91.7                |
| Realized gains (losses)                                 | (.9)         | .1           | -                      | (2.3)                     | .7                      | (2.4)               |
| Investment and other income                             | 1.5          | 8.0          | (0.1)                  | 318.0                     | (11.1)                  | 316.3               |
| Equity in earnings of subsidiaries                      | <u>174.9</u> | <u>25.0</u>  | <u>34.5</u>            | <u>15.4</u>               | <u>(249.8)</u>          | <u>-</u>            |
|   |              |              |                        | )                         |                         |                     |
|   | 175.5        | 33.1         | 34.4                   | 1,153.7                   | (260.2)                 | 1,136.5             |
| Costs and Expenses:                                     |              |              |                        |                           |                         |                     |
| Insurance benefits and expenses                         | -            | -            | -                      | 845.8                     | -                       | 845.8               |
| Interest charges on borrowed money                      | 13.6         | 0.1          | 10.2                   | 4.1                       | (9.7)                   | 18.3                |
| Other expenses  | <u>12.3</u>  | <u>2.5</u>   | <u>2.4</u>             | <u>102.3</u>              | <u>3.3</u>              | <u>122.8</u>        |
|   | <u>25.9</u>  | <u>2.6</u>   | <u>12.6</u>            | <u>952.2</u>              | <u>(6.4)</u>            | <u>986.9</u>        |
|   |              |              |                        | )                         |                         |                     |
| Earnings before income taxes                            | 149.6        | 30.5         | 21.8                   | 201.5                     | (253.8)                 | 149.6               |
| Provision for income taxes                              | <u>56.1</u>  | <u>10.7</u>  | <u>7.6</u>             | <u>68.6</u>               | <u>(86.9)</u>           | <u>56.1</u>         |
|   |              |              |                        | )                         |                         |                     |

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|  |                |               |                |                 |                  |                 |
|--|----------------|---------------|----------------|-----------------|------------------|-----------------|
| Net Earnings                             | <u>\$ 93.5</u> | <u>\$19.8</u> | <u>\$ 14.2</u> | <u>\$ 132.9</u> | <u>(\$166.9)</u> | <u>\$ 93.5</u>  |
| FOR THE NINE MONTHS ENDED                |                |               |                |                 |                  |                 |
| <u>SEPTEMBER 30, 2006</u>                |                |               |                |                 |                  |                 |
| Income                                   |                |               |                |                 |                  |                 |
| :  |                |               |                |                 |                  |                 |
| Property and casualty insurance premiums | \$ -           | \$ -          | \$ -           | \$1,925.0       | \$ -             | \$1,925.0       |
| Life, accident and health premiums       | -              | -             | -              | 249.3           | -                | 249.3           |
| Realized gains (losses)                  | (.9)           | (1.4)         | -              | 22.4            | (.2)             | 19.9            |
| Investment and other income              | 5.0            | 22.6          | (2.2)          | 950.9           | (42.9)           | 933.4           |
| Equity in earnings of subsidiaries       | <u>535.4</u>   | <u>64.8</u>   | <u>148.1</u>   | <u>65.1</u>     | <u>(813.4)</u>   | <u>-</u>        |
|  |                |               |                | )               |                  |                 |
|  | 539.5          | 86.0          | 145.9          | 3,212.7         | (856.5)          | 3,127.6         |
| Costs and Expenses:                      |                |               |                |                 |                  |                 |
| Insurance benefits and expenses          | -              | -             | -              | 2,263.0         | -                | 2,263.0         |
| Interest charges on borrowed money       | 56.0           | 0.1           | 30.7           | 10.0            | (42.9)           | 53.9            |
| Other expenses                           | <u>34.0</u>    | <u>7.5</u>    | <u>6.9</u>     | <u>300.6</u>    | <u>12.2</u>      | <u>361.2</u>    |
|  | <u>90.0</u>    | <u>7.6</u>    | <u>37.6</u>    | <u>2,573.6</u>  | <u>(30.7)</u>    | <u>2,678.1</u>  |
|  |                |               |                | )               |                  |                 |
| Earnings before income taxes             | 449.5          | 78.4          | 108.3          | 639.1           | (825.8)          | 449.5           |
| Provision for income taxes               | <u>156.9</u>   | <u>27.4</u>   | <u>38.0</u>    | <u>205.7</u>    | <u>(271.1)</u>   | <u>156.9</u>    |
|  |                |               |                | )               |                  |                 |
| Income from continuing operations        | 292.6          | 51.0          | 70.3           | 433.4           | (554.7)          | 292.6           |
| Discontinued operations, net of tax      | <u>25.3</u>    | <u>31.0</u>   | <u>-</u>       | <u>31.0</u>     | <u>(62.0)</u>    | <u>25.3</u>     |
|  |                |               |                | )               |                  |                 |
| Net Earnings                             | <u>\$317.9</u> | <u>\$82.0</u> | <u>\$ 70.3</u> | <u>\$ 464.4</u> | <u>(\$616.7)</u> | <u>\$ 317.9</u> |

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

## CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

| FOR THE NINE MONTHS ENDED<br><u>SEPTEMBER 30, 2007</u>      | <u>AFG</u>     | <u>GAFRI</u> | <u>AAG<br/>Holding</u> | <u>All Other<br/>Subs</u> | <u>Cons<br/>Entries</u> | <u>Consolidated</u> |
|---|----------------|--------------|------------------------|---------------------------|-------------------------|---------------------|
| Operating Activities:                                       |                |              |                        |                           |                         |                     |
| Net earnings  | \$ 293.3       | \$ 61.3      | \$ 51.9                | \$ 417.6                  | (\$ 530.8)              | \$ 293.3            |
| Adjustments:  |                |              |                        |                           |                         |                     |
| Equity in net earnings of subsidiaries                      | (350.6)        | (58.4)       | (74.8)                 | (36.8)                    | 520.6                   | -                   |
| Capital contribution from parent<br>(to subsidiary)         | (4.0)          | (198.8)      | 198.8                  | 4.0                       | -                       | -                   |
| Dividends from subsidiaries (to parent)                     | 244.0          | 148.1        | (112.8)                | (279.3)                   | -                       | -                   |
| Other adjustments, net                                      | <u>(224.4)</u> | <u>239.3</u> | <u>(.4)</u>            | <u>303.0</u>              | <u>10.2</u>             | <u>327.7</u>        |
| )   |                |              |                        |                           |                         | )                   |
| Net cash provided by (used in)<br>operating activities      | <u>(41.7)</u>  | <u>191.5</u> | <u>62.7</u>            | <u>408.5</u>              | <u>-</u>                | <u>621.0</u>        |
| )   |                |              |                        |                           |                         | )                   |
| Investing Activities:                                       |                |              |                        |                           |                         |                     |
| Purchase of investments, property and<br>equipment          | (4.8)          | -            | -                      | (3,348.5)                 | 17.3                    | (3,336.0)           |
| Purchase of subsidiaries                                    | (.2)           | (237.8)      | -                      | (1.7)                     | -                       | (239.7)             |
| Maturities and redemptions of fixed<br>maturity investments | 5.0            | 32.2         | -                      | 1,143.7                   | (55.4)                  | 1,125.5             |
| Sale of investments, property and<br>equipment              | 71.8           | 17.3         | -                      | 1,241.7                   | (17.3)                  | 1,313.5             |
| Other, net  | <u>-</u>       | <u>-</u>     | <u>-</u>               | <u>(97.3)</u>             | <u>-</u>                | <u>(97.3)</u>       |

|   |                |                |               |                  |               |                  |
|---|----------------|----------------|---------------|------------------|---------------|------------------|
|   |                |                |               | )                |               | )                |
| Net cash provided by (used in)                          |                |                |               |                  |               |                  |
| investing activities                                    | <u>71.8</u>    | <u>(188.3)</u> | <u>-</u>      | <u>(1,062.1)</u> | <u>(55.4)</u> | <u>(1,234.0)</u> |
|   | )              | )              | )             | )                | )             | )                |
| Financing Activities:                                   |                |                |               |                  |               |                  |
| Annuity receipts  | -              | -              | -             | 1,204.5          | -             | 1,204.5          |
| Annuity surrenders, benefits and<br>withdrawals         | -              | -              | -             | (1,057.3)        | -             | (1,057.3)        |
| Net transfers from variable annuity assets              | -              | -              | -             | 51.3             | -             | 51.3             |
| Additional long-term borrowings                         | 50.0           | -              | 92.0          | -                | -             | 142.0            |
| Reductions of long-term debt                            | (60.5)         | (.1)           | (154.3)       | (8.0)            | 55.4          | (167.5)          |
| Issuances of Common Stock                               | 13.5           | -              | -             | 1.0              | -             | 14.5             |
| Repurchases of Common Stock                             | (133.4)        | -              | -             | -                | -             | (133.4)          |
| Other, net  | <u>(31.7)</u>  | <u>3.2</u>     | <u>-</u>      | <u>(12.4)</u>    | <u>-</u>      | <u>(40.9)</u>    |
|   | )              | )              | )             | )                | )             | )                |
| Net cash provided by (used in)                          |                |                |               |                  |               |                  |
| financing activities                                    | <u>(162.1)</u> | <u>3.1</u>     | <u>(62.3)</u> | <u>179.1</u>     | <u>55.4</u>   | <u>13.2</u>      |
|   | )              | )              | )             | )                | )             | )                |
| Net increase (decrease) in cash and<br>cash equivalents | (132.0)        | 6.3            | .4            | (474.5)          | -             | (599.8)          |
| Cash and cash equivalents at beginning<br>of period     | <u>146.0</u>   | <u>2.8</u>     | <u>-</u>      | <u>1,180.2</u>   | <u>-</u>      | <u>1,329.0</u>   |
| Cash and cash equivalents at end of period              | <u>\$ 14.0</u> | <u>\$ 9.1</u>  | <u>\$ .4</u>  | <u>\$ 705.7</u>  | <u>\$ -</u>   | <u>\$ 729.2</u>  |

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

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| FOR THE NINE MONTHS ENDED<br><u>SEPTEMBER 30, 2006</u>         | <u>AFG</u>   | <u>GAFRI</u>   | <u>AAG<br/>Holding</u> | <u>All Other<br/>Subs</u> | <u>Cons<br/>Entries</u> | <u>Consolidated</u> |
|--|--------------|----------------|------------------------|---------------------------|-------------------------|---------------------|
| <b>Operating Activities:</b>                                   |              |                |                        |                           |                         |                     |
| Net earnings   | \$ 317.9     | \$ 82.0        | \$70.3                 | \$ 464.4                  | (\$616.7)               | \$ 317.9            |
| <b>Adjustments:</b>  |              |                |                        |                           |                         |                     |
| Equity in net earnings of subsidiaries                         | (365.2)      | (73.5)         | (96.3)                 | (65.1)                    | 600.1                   | -                   |
| Capital contribution from parent<br>(to subsidiary)            | (2.5)        | (92.6)         | 92.6                   | 2.5                       | -                       | -                   |
| Dividends from subsidiaries (to parent)                        | 2.5          | 271.7          | (63.7)                 | (210.5)                   | -                       | -                   |
| Other adjustments, net   | <u>40.5</u>  | <u>12.5</u>    | <u>(1.3)</u>           | <u>411.5</u>              | <u>16.6</u>             | <u>479.8</u>        |
|  |              |                | )                      |                           |                         |                     |
| Net cash provided by (used in)<br>operating activities         | <u>(6.8)</u> | <u>200.1</u>   | <u>1.6</u>             | <u>602.8</u>              | <u>-</u>                | <u>797.7</u>        |
|  |              |                | )                      |                           |                         |                     |
| <b>Investing Activities:</b>                                   |              |                |                        |                           |                         |                     |
| Purchase of investments, property and<br>equipment             | (.4)         | -              | -                      | (2,173.2)                 | -                       | (2,173.6)           |
| Purchase of subsidiaries                                       | -            | (204.4)        | -                      | (2.6)                     | -                       | (207.0)             |
| Proceeds received from sale of subsidiary                      | -            | 37.5           | -                      | -                         | -                       | 37.5                |
| Maturities and redemptions of fixed<br>maturity investments    | 19.4         | 1.2            | -                      | 687.9                     | -                       | 708.5               |
| Cash and short-term investments of<br>businesses acquired, net | -            | -              | -                      | 201.9                     | -                       | 201.9               |
| Sale of investments, property and<br>equipment                 | 45.3         | 37.0           | -                      | 1,316.7                   | -                       | 1,399.0             |
| Other, net   | <u>-</u>     | <u>-</u>       | <u>-</u>               | <u>(197.9)</u>            | <u>-</u>                | <u>(197.9)</u>      |
|  |              |                | )                      |                           | )                       |                     |
| Net cash provided by (used in)<br>investing activities         | <u>64.3</u>  | <u>(128.7)</u> | <u>-</u>               | <u>(167.2)</u>            | <u>-</u>                | <u>(231.6)</u>      |
|  |              |                | )                      |                           | )                       |                     |
| <b>Financing Activities:</b>                                   |              |                |                        |                           |                         |                     |
| Annuity receipts   | -            | -              | -                      | 914.3                     | -                       | 914.3               |



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|  |                |                |              |                  |             |                  |
|--|----------------|----------------|--------------|------------------|-------------|------------------|
| Annuity surrenders, benefits and withdrawals         | -              | -              | -            | (898.6)          | -           | (898.6)          |
| Net transfers from variable annuity assets           | -              | -              | -            | 17.8             | -           | 17.8             |
| Additional long-term borrowings                      | -              | -              | 65.0         | 52.5             | -           | 117.5            |
| Reductions of long-term debt                         | (45.8)         | (68.9)         | (66.9)       | (25.4)           | -           | (207.0)          |
| Issuances of Common Stock                            | 27.9           | -              | -            | -                | -           | 27.9             |
| Other, net   | <u>(28.5)</u>  | <u>3.1</u>     | <u>-</u>     | <u>155.4</u>     | <u>-</u>    | <u>130.0</u>     |
| )  |                |                |              |                  |             |                  |
| Net cash provided by (used in) financing activities  | <u>(46.4)</u>  | <u>(65.8)</u>  | <u>(1.9)</u> | <u>216.0</u>     | <u>-</u>    | <u>101.9</u>     |
| ) ) )  |                |                |              |                  |             |                  |
| Net increase (decrease) in cash and cash equivalents | 11.1           | 5.6            | (0.3)        | 651.6            |             | 668.0            |
| Cash and cash equivalents at beginning of period     | <u>20.9</u>    | <u>7.9</u>     | <u>0.3</u>   | <u>442.7</u>     | <u>-</u>    | <u>471.8</u>     |
| Cash and cash equivalents at end of period           | <u>\$ 32.0</u> | <u>\$ 13.5</u> | <u>\$ -</u>  | <u>\$1,094.3</u> | <u>\$ -</u> | <u>\$1,139.8</u> |

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AMERICAN FINANCIAL GROUP, INC. 10-Q

ITEM 2

Management's Discussion and Analysis

of Financial Condition and Results of Operations

INDEX TO MD&A

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## FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of words such as "anticipates", "believes", "expects", "estimates", "intends", "plans", "seeks", "could", "may", "should", "will" or the negative version of those words or other comparable terminology. Such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings and investment activities; recoverability of asset values; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate increases; and improved loss experience.

Actual results could differ materially from those contained in or implied by such forward-looking statements for a variety of factors including:

- ◆ changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;
- ◆ regulatory actions;
- ◆ changes in the legal environment affecting AFG or its customers;
- ◆ tax law changes;
- ◆ levels of natural catastrophes, terrorist events (including any nuclear, biological, chemical, or radiological events), incidents of war and other major losses;
- ◆ development of insurance loss reserves and other reserves, particularly with respect to amounts associated with asbestos and environmental claims;
- ◆ the unpredictability of possible future litigation;
- ◆ trends in persistency, mortality and morbidity;
- ◆ availability of reinsurance and ability of reinsurers to pay their obligations;
- ◆ competitive pressures, including the ability to obtain rate increases; and
- ◆ changes in debt and claims paying ratings.

The forward-looking statements herein are made only as of the date of this report. The Company assumes no obligation to publicly update any forward-looking statements.

## OVERVIEW

### Financial Condition

AFG is organized as a holding company with almost all of its operations being conducted by subsidiaries. AFG, however, has continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends, and taxes. Therefore, certain analyses are best done on a parent only basis while others are best done on a total enterprise basis. In

addition, because most of its businesses are financial in nature, AFG does not prepare its consolidated financial statements using a current-noncurrent format. Consequently, certain traditional ratios and financial analysis tests are not meaningful.

At September 30, 2007, AFG (parent) had approximately \$49 million in cash and securities and no amounts borrowed under the bank line of credit. AAG Holding had \$16 million borrowed under this line at September 30, 2007.

## Results of Operations

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance, and in the sale of traditional fixed, indexed and variable annuities and a variety of supplemental insurance products.

AFG's net earnings for the third quarter and first nine months of 2007 were \$112.7 million (\$.93 per share, diluted) and \$293.3 million (\$2.40 per share, diluted), respectively, compared to \$93.5 million (\$.77 per share, diluted) and \$317.9 million (\$2.64 per share) reported in the same periods of 2006. The improvement for the third quarter reflects higher earnings from the property and casualty insurance operations.

For the nine months, higher earnings from the ongoing property and casualty operations were more than offset by lower gains from sales of real estate, and the effect of charges to strengthen reserves for asbestos and other environmental exposures ("A&E") within the property and casualty insurance run-off operations and A&E reserves related to former railroad and manufacturing operations.

## CRITICAL ACCOUNTING POLICIES

Significant accounting policies are summarized in Note A to the financial statements. The preparation of financial statements requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions change and thus impact amounts reported in the future. The areas where management believes the degree of judgment required to determine amounts recorded in the financial statements make accounting policies critical are as follows:

- the establishment of insurance reserves, especially asbestos and environmental-related reserves,
- the recoverability of reinsurance,
- the recoverability of deferred acquisition costs,
- the establishment of asbestos and environmental reserves of former railroad and manufacturing operations, and
- the determination of "other-than-temporary" impairment on investments.

For a discussion of these policies, see *Management's Discussion and Analysis - "Critical Accounting Policies" in AFG's 2006 Form 10-K*.

## LIQUIDITY AND CAPITAL RESOURCES

Ratios

AFG's debt to total capital ratio on a consolidated basis is shown below (dollars in millions).

|                                       | September 30, | <u>December 31,</u> |             |
|---------------------------------------|---------------|---------------------|-------------|
|                                       | <u>2007</u>   | <u>2006</u>         | <u>2005</u> |
| Long-term debt                        | \$ 897        | \$ 921              | \$1,000     |
| Total capital (*)                     | 4,083         | 4,160               | 3,703       |
| Ratio of debt to total capital:       |               |                     |             |
| Including debt secured by real estate | 22.0%         | 22.1%               | 27.0%       |
| Excluding debt secured by real estate | 20.7%         | 20.9%               | 26.3%       |

(\*) Includes long-term debt, minority interest and shareholders' equity (excluding unrealized gains (losses) related to fixed maturity investments).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 2.46 for the nine months ended September 30, 2007 and 2.62 for the entire year of 2006. Excluding annuity benefits, this ratio was 8.73 and 9.15, respectively. Although the ratio excluding interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

Sources of Funds

## Parent Holding Company Liquidity

Management believes AFG has sufficient resources to meet its liquidity requirements. If funds generated from operations, including dividends and tax payments from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to utilize parent company cash and marketable securities or generate cash through borrowings, sales of other assets, or similar transactions.

In March 2006, AFG and AAG Holding replaced their existing credit agreements with a five-year revolving credit facility under which they can borrow a combined \$500 million. AAG Holding had \$16 million in borrowings outstanding under this agreement at September 30, 2007, bearing interest at a rate of 6.3% at September 30, 2007.

During the first nine months of 2007, AFG repurchased 4.7 million shares of its common stock for approximately \$133 million. AFG continued repurchasing its shares in the fourth quarter using cash on hand and borrowings under its bank line. Through November 7, AFG has repurchased an additional 1.2 million shares for approximately \$36 million.

Under a currently effective shelf registration statement, AFG can offer additional equity or debt securities. The shelf registration provides AFG with greater flexibility to access the capital markets from time to time as market and other conditions permit.

## Subsidiary Liquidity

On March 1, 2007, AAG Holding used funds borrowed under the bank credit line to redeem its \$22 million in outstanding 8-7/8% Subordinated Debentures for \$22.9 million in cash.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

The liquidity requirements of AFG's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, payments of dividends and taxes to AFG and contributions of capital to their subsidiaries. Historically, cash flows from premiums and investment income have provided more than sufficient funds to meet these requirements without requiring a sale of investments or contributions from AFG. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments.

The excess cash flow of AFG's property and casualty group allows it to extend the duration of its investment portfolio somewhat beyond that of its claim reserves.

In the annuity business, where profitability is largely dependent on earning a "spread" between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. With declining rates, AFG receives some protection (from spread compression) due to the ability to lower crediting rates, subject to guaranteed minimums. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on AFG's annuity products.

AFG believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits and operating expenses, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

#### Investments

AFG's investment portfolio at September 30, 2007, contained \$15.1 billion in "Fixed maturities" classified as available for sale and \$1.0 billion in "Equity securities," all carried at fair value with unrealized gains and losses included in a separate component of shareholders' equity on an after-tax basis. At September 30, 2007, AFG had a pretax net unrealized loss of \$139 million on fixed maturities and a pretax net unrealized gain of \$73 million on other stocks.

Approximately 94% of the fixed maturities held by AFG at September 30, 2007, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and noninvestment grade. Management believes that a high quality investment portfolio should generate a stable and predictable investment return.

Since fixed maturities and stocks are carried at fair value in the balance sheet, there is virtually no effect on financial condition upon the sale and ultimate realization of unrealized gains and losses.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2007, is shown in the following table (dollars in millions). Approximately \$175 million of available for sale "Fixed maturities" had no unrealized gains or losses at September 30, 2007.

|  | Securities<br>With<br>Unrealized<br><u>Gains</u> | Securities<br>With<br>Unrealized<br><u>Losses</u> |
|--|--|---|
| <u>Available for Sale Fixed Maturities</u>   |  |   |
| Fair value of securities   | \$4,483  | \$10,457  |
| Amortized cost of securities   | \$4,375  | \$10,704  |
| Gross unrealized gain (loss)   | \$ 108   | (\$ 247)  |
| Fair value as % of amortized cost  | 102%   | 98%   |
| Number of security positions   | 1,320  | 1,550   |
| Number individually exceeding<br>\$2 million gain or loss                            | 1  | 4   |
| Concentration of gains (losses) by type or<br>industry (exceeding 5% of unrealized): |  |   |
| Mortgage-backed securities   | \$24.5   | (\$94.8)  |
| Banks, savings and credit institutions   | 8.8  | (48.6)  |
| Insurance companies  | 5.7  | (15.0)  |
| Gas and electric services  | 11.2   | (13.5)  |
| Percentage rated investment grade  | 93%  | 95%   |

Approximately 99% of AFG's mortgage-backed securities are rated "AAA." At September 30, 2007, AFG owned \$498 million (representing 3% of AFG's total fixed maturity portfolio) of mortgage-backed securities in which the underlying collateral is sub-prime mortgages. At that date, the net unrealized loss on these securities was approximately \$11.3 million. The securities are collateralized by fixed-rate mortgages and have an overall average life of approximately 3 years. None of the securities have been subject to downgrades or "watch listing" by rating agencies. At September 30, 2007, AFG had no collateralized debt obligations secured by residential mortgages.

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at September 30, 2007, based on their fair values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

Securities                      Securities

|                                    | <u>With<br/>Unrealized<br/>Gains</u> | <u>With<br/>Unrealized<br/>Losses</u> |
|------------------------------------|--------------------------------------|---------------------------------------|
| <u>Maturity</u>                    |                                      |                                       |
| One year or less                   | 3%                                   | 3%                                    |
| After one year through five years  | 39                                   | 19                                    |
| After five years through ten years | 29                                   | 35                                    |
| After ten years                    | <u>9</u>                             | <u>6</u>                              |
| <br>                               |                                      |                                       |
| Mortgage-backed securities         | 80<br><u>20</u>                      | 63<br><u>37</u>                       |
|                                    | <u>100</u>                           | <u>100</u>                            |
|                                    | %                                    | %                                     |

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

The table below (dollars in millions) summarizes the unrealized gains and losses on fixed maturity securities by dollar amount.

|  | <u>Aggregate<br/>Fair<br/>Value</u> | <u>Aggregate<br/>Unrealized<br/>Gain (Loss)</u> | <u>Fair<br/>Value as<br/>% of Cost<br/>Basis</u> |
|--|-------------------------------------|---|--|
|--|-------------------------------------|---|--|

Fixed Maturities at September 30, 2007

|                                    |                 |              |      |
|------------------------------------|-----------------|--------------|------|
| Securities with unrealized gains:  |                 |              |      |
| Exceeding \$500,000 (32 issues)    | \$ 269          | \$ 27        | 111% |
| Less than \$500,000 (1,288 issues) | <u>4,214</u>    | <u>81</u>    | 102  |
|                                    | <u>\$ 4,483</u> | <u>\$108</u> | 102% |

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|                                    |                 |                |     |
|------------------------------------|-----------------|----------------|-----|
| Securities with unrealized losses: |                 |                |     |
| Exceeding \$500,000 (121 issues)   | \$ 2,264        | (\$105)        | 96% |
| Less than \$500,000 (1,429 issues) | <u>8,193</u>    | <u>(142)</u>   | 98  |
|                                    | <u>\$10,457</u> | <u>(\$247)</u> | 98% |

The following table summarizes (dollars in millions) the unrealized loss for all fixed maturity securities with unrealized losses by issuer quality and length of time those securities have been in an unrealized loss position.

|  | <u>Aggregate<br/>Fair<br/>Value</u> | <u>Aggregate<br/>Unrealized<br/>Loss</u> | <u>Fair<br/>Value as<br/>% of Cost<br/>Basis</u> |
|--|-------------------------------------|--|--|
| <u>Fixed Maturities with Unrealized<br/>Losses at September 30, 2007</u> |                                     |  |  |
| Investment grade with losses for:  |                                     |  |  |
| One year or less (428 issues)  | \$ 3,443                            | (\$ 61)                                  | 98%  |
| Greater than one year (983 issues)                                       | <u>6,456</u>                        | <u>(165)</u>                             | 98   |
|  | <u>\$ 9,899</u>                     | <u>(\$226)</u>                           | 98%  |
| Non-investment grade with losses for:                                    |                                     |  |  |
| One year or less (102 issues)  | \$ 371                              | (\$ 14)                                  | 96%  |
| Greater than one year (37 issues)  | <u>187</u>                          | <u>(7)</u>                               | 96   |
|  | <u>\$ 558</u>                       | <u>(\$ 21)</u>                           | 96%  |

When a decline in the value of a specific investment is considered to be "other than temporary," a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are "other than temporary" requires judgment based on subjective as well as objective factors. A listing of factors considered and resources used is contained in the discussion of "Investments" under *Management's Discussion and Analysis in AFG's 2006 Form 10-K*.

Based on its analysis, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they mature or recover in value. Although AFG has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a



particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains. Should AFG's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary impairment could be material to

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

results of operations in a future period. Management believes it is not likely that future impairment charges will have a significant effect on AFG's liquidity.

Uncertainties

Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and contingencies arising out of its former railroad and manufacturing operations. See *Management's Discussion and Analysis - "Uncertainties"* in AFG's 2006 Form 10-K.

RESULTS OF OPERATIONS

General

Results of operations as shown in the accompanying financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP").

Operating earnings before income taxes for the third quarter of 2007 improved by \$26.5 million (17%) compared to the 2006 quarter reflecting a \$22.5 million improvement in Specialty property and casualty underwriting results.

Nine month pretax operating earnings improved by \$17.5 million (4%) compared to the 2006 period. A \$93.9 million improvement in Specialty property and casualty underwriting results was offset by second quarter 2007 charges of \$44.2 million to strengthen reserves for A&E exposure within the property and casualty insurance run-off operations and \$43.0 million to increase A&E reserves related to former railroad and manufacturing operations. Results for the nine months of 2007 also include \$11.6 million in net realized gains on securities compared to \$19.9 million in the 2006 period.

Property and Casualty Insurance - Underwriting

AFG reports its Specialty insurance business in the following sub-segments: (i) Property and transportation, (ii) Specialty casualty, (iii) Specialty financial and (iv) California workers' compensation.

Performance measures such as underwriting profit or loss and related combined ratios are often used by property and casualty insurers to help users of their financial statements better understand the company's performance. See *Note C - "Segments of Operations"* for the detail of AFG's operating profit by significant business segment.

Underwriting profitability is measured by the combined ratio, which is a sum of the ratios of losses, loss adjustment expenses, underwriting expenses and policyholder dividends to premiums. A combined ratio under 100% is indicative of an underwriting profit. The combined ratio does not reflect investment income, other income or federal income taxes.

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## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Premiums and combined ratios for AFG's property and casualty insurance operations were as follows (dollars in millions):

|                                      | Three months ended   |                | Nine months ended    |                |
|--------------------------------------|----------------------|----------------|----------------------|----------------|
|                                      | <u>September 30.</u> |                | <u>September 30.</u> |                |
|                                      | <u>2007</u>          | <u>2006</u>    | <u>2007</u>          | <u>2006</u>    |
| <u>Gross Written Premiums (GAAP)</u> |                      |                |                      |                |
| Property and transportation          | \$ 775               | \$ 638         | \$1,519              | \$1,356        |
| Specialty casualty                   | 319                  | 371            | 1,030                | 1,113          |
| Specialty financial                  | 163                  | 142            | 440                  | 396            |
| California workers' compensation     | 61                   | 70             | 190                  | 230            |
| Other                                | <u>1</u>             | <u>1</u>       | <u>1</u>             | <u>1</u>       |
|                                      | <u>\$1,319</u>       | <u>\$1,222</u> | <u>\$3,180</u>       | <u>\$3,096</u> |
| <u>Net Written Premiums (GAAP)</u>   |                      |                |                      |                |
| Property and transportation          | \$ 393               | \$ 332         | \$ 915               | \$ 831         |
| Specialty casualty                   | 195                  | 238            | 620                  | 646            |
| Specialty financial                  | 131                  | 116            | 367                  | 313            |
| California workers' compensation     | 56                   | 66             | 178                  | 217            |
| Other                                | <u>23</u>            | <u>18</u>      | <u>55</u>            | <u>58</u>      |

\$ 798            \$ 770            \$2,135            \$2,065

Combined Ratios (GAAP)

|  |       |       |       |       |
|--|-------|-------|-------|-------|
| Property and transportation              | 83.3% | 87.4% | 85.0% | 84.7% |
| Specialty casualty                       | 81.1  | 78.7  | 73.7  | 85.3  |
| Specialty financial                      | 93.4  | 121.8 | 93.6  | 107.5 |
| California workers' compensation         | 77.5  | 63.6  | 78.7  | 75.7  |
| Total Specialty                          | 86.2  | 88.7  | 84.1  | 88.1  |
| Aggregate (including discontinued lines) | 86.6% | 88.9% | 86.5% | 88.4% |

Net written premiums for the Specialty insurance operations increased 4% for the third quarter and 3% for the first nine months compared to the same periods in 2006. Premium growth has been impacted by significant rate declines in the California workers' compensation business and stronger competition in certain of the Specialty casualty group operations. Excluding California workers' compensation, the net written premiums of the other specialty groups grew 5% for the quarter and 6% for the nine months compared to the 2006 periods. Apart from rate decreases in the California workers' compensation business, average rate levels in AFG's other specialty operations were down about 2% through the first nine months of the year.

The Specialty insurance operations generated an underwriting profit of \$104.8 million in the 2007 third quarter, \$22.5 million higher than the same quarter a year earlier. This improvement was largely due to increased crop earnings due to favorable crop prices and yields. The results for the 2007 quarter include \$25.8 million (3.4 points) of favorable reserve development compared to \$27.6 million (3.8 points) of favorable development in the 2006 third quarter. Underwriting profit of the Specialty insurance operations was \$322.8 million for the first nine months of 2007, 41% above the 2006 period, reflecting the positive impact of favorable reserve development within the Specialty casualty group and lower catastrophe losses. The results for the nine months of 2007 include \$124.8 million (6.2 points) of favorable reserve development compared to \$51.1 million (2.7 points) of favorable development in the 2006 period.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Property and transportation

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gross written premiums for the 2007 three and nine month periods were 22% and 12% higher than in the respective 2006 periods due primarily to growth in the crop operations. Net written premiums were 18% and 10% higher than the respective 2006 periods. These businesses reported an underwriting profit of \$58.5 million in the 2007 third quarter, \$18.1 million higher than the 2006 third quarter. The combined ratio for the quarter of 83.3% improved 4.1 points over the 2006 quarter due primarily to higher underwriting profits in the agricultural operations. These results were partially offset by higher underwriting losses in a run-off homebuilders' operation. Even though the combined ratio for the 2007 nine-month period is up slightly from the 2006 period, underwriting profit increased 8% due primarily to premium growth. The nine-month results include \$33.6 million (4.1 points) of favorable reserve development compared to \$31.9 million (4.3 points) in the 2006 period.

### Specialty casualty

gross written premiums for the 2007 three and nine month periods were down 14% and 8% compared to the respective 2006 periods due primarily to stronger competition in the excess and surplus lines and less activity in the construction market which affect the general liability coverages. Net written premiums were down 18% and 4% compared to the respective 2006 periods. This group reported a combined ratio of 81.1% for the 2007 third quarter, an increase of 2.4 points over the 2006 third quarter. The 2007 results include \$16.0 million (7.7 points) of favorable reserve development compared to \$10.0 million (4.8 points) in the same quarter a year earlier. Through the first nine months of 2007, this group's combined ratio improved 11.6 points compared with the same prior year period, primarily due to favorable reserve development in the general liability and excess and surplus lines. These operations have continued to generate excellent accident year underwriting results in 2007.

### Specialty financial

gross written premiums for the 2007 three and nine month periods were 14% and 11% higher than in the respective 2006 periods due primarily to growth in the financial institutions, lease and loan and surety operations, which was partially offset by lower premiums resulting from the run-off of the residual value insurance ("RVI") business. Net written premiums were 14% and 17% higher than the respective 2006 periods. The higher net premium growth rate for the nine months resulted from greater premium retention in the group's lease and loan operations. The 28.4 point improvement for the quarter and 13.9 point improvement for the nine months in the combined ratio compared to the 2006 periods reflect lower losses in the run-off RVI business and continued strong performance by the other businesses in this group. Excluding the effect of RVI, the group's combined ratio would have been 88.6% for the first nine months of 2007 compared to 93.7% for the comparable 2006 period. The adverse financial impact of RVI is expected to be substantially complete by the end of 2007.

### California workers' compensation

gross written premiums for the 2007 three and nine month periods were down 12% and 17% compared to the respective 2006 periods due to lower premium rates. These rate reductions averaged about 23% through the first nine months of the year, demonstrating the positive impact of reform in lowering workers' compensation costs in California. Net written premiums were down 14% and 18% compared to the respective 2006 periods. This business continues to report excellent profitability. The third quarter of 2007 includes 10.2 points of favorable prior year development while the 2006 third quarter includes 22.3 points of favorable development. Through the first nine months of 2007, the combined ratio increased 3.0 points compared to the 2006 period.

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Year-to-date 2007 results include 8.8 points of favorable development compared to 7.5 points in the 2006 period. The improved claims environment resulting from the California workers' compensation reform legislation has continued to benefit this group's results as well as those of the industry. Due to the long-tail nature of this business, we have continued to be conservative in recognizing the benefits from the reform legislation until a higher percentage of claims are paid and the ultimate impact of reforms can be determined.

Asbestos and Environmental Reserve Charge

In July 2007, AFG completed a comprehensive study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty group and its exposures related to former railroad and manufacturing operations and sites. Similar studies were completed in 2005 and 2003, respectively. The studies were done with the aid of respected outside actuarial and engineering firms and specialty outside counsel.

As a result of the study, AFG recorded a \$44.2 million charge (net of reinsurance) in the second quarter of 2007 to increase the property and casualty group's asbestos reserves by \$30.8 million and its environmental reserves by \$13.4 million. At September 30, 2007, the property and casualty group's A&E reserves were \$446.0 million, net of reinsurance recoverables. At that date, AFG's three year survival ratio was 17.0 times paid losses for the asbestos reserves and 11.1 times paid losses for the total A&E reserves. These ratios compare favorably with A.M. Best's most recent report on A&E survival ratios (March 2007) which were 9.0 for asbestos and 8.0 for total industry A&E reserves. Excluding amounts associated with the settlements of asbestos related coverage litigation for A.P. Green Industries (see "*Legal Proceedings*" in AFG's 2006 Form 10-K) and another large claim, AFG's three year survival ratio was 10.2 and 7.6 times paid losses for the asbestos reserves and total A&E reserves, respectively.

The primary causes of the increase

in asbestos reserves were an increase in settlement amounts attributable to mesothelioma claims, the impact of a large case settlement with an installer of material containing asbestos, and continuing uncertainties related to non-product liability exposures. These trends were partially offset by lower than anticipated notices of new accounts and favorable development in our assumed reinsurance run-off operations. The primary reason for the increase in environmental reserves was a reassessment of the potential amount of loss related to certain environmental sites owned by a single insured.

In addition to the property and casualty group, the study encompassed reserves for asbestos and environmental exposures of our former railroad and manufacturing operations. As a result of the study, AFG recorded a second quarter 2007 charge of \$43.0 million (included in other expenses) to increase the A&E reserves related to these former operations. The \$19.0 million increase in asbestos reserves was the result of increasing estimates of the cost of mesothelioma claims partially offset by lower estimated overall claim counts. The \$24.0 million increase in environmental reserves was due primarily to increased clean up estimates at certain former railroad and manufacturing sites.

The study relied on a ground-up exposure analysis. With respect to asbestos, it considered products and non-products exposures, paid claims history, the pattern of new claims, settlements and projected development. The asbestos legal climate remains very difficult to predict. While some progress has been made in state asbestos tort reform and judicial rulings, that progress has been somewhat offset by increased claims costs, increased defense costs, the assertion of non-products theories and an expanding pool of plaintiffs and defendants.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - ContinuedLife, Accident and Health Premiums and Benefits

The increase in life, accident and health premiums and benefits in the third quarter and first nine months of 2007 compared to the same 2006 periods reflects the August 2006 acquisition of Ceres.

Investment Income

The increase in investment income for the third quarter and first nine months of 2007 compared to the same periods in 2006 reflects an increase in average cash and investments of approximately \$1.1 billion (7%) for the third quarter and \$1.3 billion (8%) for the nine months.

Realized Gains

Realized capital gains have been an important part of the return on investments. Individual assets are sold creating gains and losses as market opportunities exist. Realized gains for 2006 includes a \$23.6 million pretax gain in the first quarter on the sale of AFG's interest in The Cincinnati Reds.

Realized gains on securities include provisions for other than temporary impairment of securities as follows: third quarter of 2007 and 2006 - \$18.2 million and \$7.1 million; nine months of 2007 and 2006 - \$29.5 million and \$12.9 million, respectively.

Real Estate Operations

AFG's subsidiaries are engaged in a variety of real estate operations including hotels, marinas, apartments and office buildings; they also own several parcels of land. Revenues and expenses of these operations, including gains and losses on disposal, are included in AFG's Statement of Earnings as shown below (in millions).

|                                      | Three months ended   |             | Nine months ended    |             |
|--------------------------------------|----------------------|-------------|----------------------|-------------|
|                                      | <u>September 30.</u> |             | <u>September 30.</u> |             |
|                                      | <u>2007</u>          | <u>2006</u> | <u>2007</u>          | <u>2006</u> |
| Other income                         | \$17.3               | \$20.7      | \$64.8               | \$65.8      |
| Other operating and general expenses | 17.2                 | 18.7        | 48.9                 | 50.2        |
| Interest charges on borrowed money   | 1.0                  | .9          | 3.1                  | 1.6         |
| Minority interest expense            | (.1)                 | .1          | -                    | 2.3         |

Income from real estate operations includes net pretax gains on the sale of real estate assets of \$12.7 million in the first nine months of 2007 compared to \$14.2 million for the 2006 period.

#### Real Estate Operations - Discontinued

In June 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for \$166 million. After sales expenses, contingencies and the write-off of certain deferred acquisition costs on annuities associated with the gain recognition, GAFRI recognized a pretax gain of approximately \$48.7 million. In the second quarter of 2007, GAFRI received an additional escrow payment in connection with the sale. Chatham's 2006 operating results and the gains on the sale of Chatham are reported as discontinued operations in the Statement of Earnings.

#### Other Income

The \$25.9 million (11%) increase for the first nine months of 2007 compared to the 2006 period is due primarily to fee income generated from reinsurance agreements entered into in connection with the Ceres acquisition in August 2006 and higher fee income in the property and casualty dealer services business.

#### Annuity Benefits

Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. On deferred annuities (annuities in the accumulation phase), interest is generally credited to policyholders' accounts at current stated interest rates. Furthermore, for "two-tier" deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather

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#### Management's Discussion and Analysis

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than surrendered), additional reserves are accrued for (i) persistency and premium bonuses and (ii) excess benefits expected to be paid for future deaths and annuitizations. Changes in crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect these additional reserves. Significant changes in projected investment yields could result in charges (or credits) to earnings in the period the projections are modified.

Annuity benefits increased \$6.1 million for the third quarter and \$18.5 million the first nine months of 2007 compared to the 2006 periods, reflecting higher sales of fixed-indexed annuities.

#### Annuity and Supplemental Insurance Acquisition Expenses

Annuity and supplemental insurance acquisition expenses include amortization of annuity, supplemental insurance and life business deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Annuity and supplemental insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired ("PVFP"). The \$23.2 million increase in annuity and supplemental insurance

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acquisition expenses for the first nine months of 2007 compared to the 2006 period reflects growth in the annuity and supplemental insurance business as well as the acquisition of Ceres in August 2006.

The vast majority of the annuity and supplemental insurance group's DPAC asset relates to its fixed annuity, variable annuity and life insurance lines of business. Unanticipated spread compression, decreases in the stock market, adverse mortality experience and higher than expected lapse rates could lead to write-offs of DPAC or PVFP in the future.

### Other Operating and General Expenses

Other operating and general expenses increased \$71.5 million (21%) for the first nine months of 2007 compared to the 2006 period. Other operating and general expenses for 2007 include a \$43.0 million second quarter charge to increase liabilities related to asbestos and environmental exposures related to AFG's former railroad and manufacturing operations and a \$12.5 million second quarter charge related to a consumer services contract in AFG's warranty business. For a discussion of the study that resulted in the A&E charge, see "*Asbestos and Environmental Reserve Charge*" under *Results of Operations - "Property and Casualty Insurance - Underwriting."* Other operating and general expenses also include \$1.4 million and \$7.2 million in losses on retirement of debt in the first nine months of 2007 and 2006, respectively.

### Income Taxes

Income tax expense reflects benefits of \$3.5 million in the second quarter of 2007 and \$8.7 million in the second quarter of 2006 related to the favorable resolution of certain tax issues.

### Recent Accounting Standards

In 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which defines and establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective January 1, 2008, for calendar year companies; implementation is not expected to have a material effect on AFG's balance sheet or earnings.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," which permits entities to

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irrevocably elect to report certain financial assets and liabilities (including most insurance contracts) at fair value and recognize the unrealized gains and losses on such items in earnings. SFAS No. 159 is effective January 1, 2008, for calendar year companies. AFG is currently evaluating whether it will elect the fair value option for any of its eligible assets or liabilities.

### Proposed Accounting Standards



## Convertible Notes

In August 2007, the FASB issued a proposed FASB Staff Position (FSP 14-a) addressing convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement). The proposed FSP would require the proceeds from the issuance of such debt instruments to be allocated between a liability component and an equity component. The resulting debt discount would be amortized as additional interest expense over the period the convertible debt is expected to be outstanding. The proposed change in accounting would be effective for fiscal years beginning after December 15, 2007, and applied retroactively. AFG is currently evaluating the impact of implementing this proposal.

The FASB has proposed an amendment to SFAS No. 128, "Earnings per Share." Currently, SFAS No. 128 allows companies issuing securities that can be settled in cash or stock (such as AFG's convertible notes) to exclude the issuable shares from the calculation of diluted earnings per share when there is a stated intent and ability to deliver cash in lieu of stock upon settlement or conversion. The proposed statement would require companies to assume settlement in stock (despite the ability and intent to settle in cash) and include those shares in the calculation of diluted earnings per share.

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## ITEM 3

### Quantitative and Qualitative Disclosure of Market Risk

As of September 30, 2007, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure of Market Risk" of AFG's 2006 Form 10-K.

## ITEM 4

### Controls and Procedures

AFG's management, with participation of its Co-Chief Executive Officers and its principal financial officer, has evaluated AFG's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, AFG's Co-CEOs and principal financial officer concluded that the controls and procedures are effective. There have been no changes in AFG's internal control over financial reporting during the third fiscal quarter of 2007 that materially affected, or are reasonably likely to materially affect, AFG's internal control over financial reporting.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. There has been no change in AFG's business processes and procedures during the third fiscal quarter of 2007 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

## OTHER INFORMATION

## ITEM 1

Legal Proceedings

As previously reported under "Legal Proceedings" in AFG's 2006 Form 10-K, Great American Insurance Company entered into an agreement in 2003, which was approved by the bankruptcy court, for the settlement of coverage litigation related to A.P. Green asbestos claims. The settlement is for \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest). The agreement allows up to 10% of the settlement to be paid in AFG Common Stock. The settlement agreement is conditioned upon confirmation of a plan of reorganization that includes an injunction prohibiting the assertion against Great American of any present or future asbestos personal injury claims under policies issued to A.P. Green and related companies.

During the third quarter of 2007, the Bankruptcy Court confirmed the A.P. Green Plan of Reorganization which includes the injunction required by Great American's settlement agreement. Counsel for the Debtor notified Great American that it is likely that such confirmation will be appealed; Great American is not required to fund the settlement agreement until confirmation is final and non-appealable.

## ITEM 2

Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities

AFG repurchased shares of its common stock during the third quarter of 2007 as follows:

| <u>Period</u>           | <u>Total<br/>Number<br/>of Shares<br/>Purchased</u> | <u>Average<br/>Price Paid<br/>Per Share</u> | <u>Total Number<br/>of Shares<br/>Purchased as<br/>Part of Publicly<br/>Announced Plans<br/>or Programs</u> | <u>Maximum Number<br/>of Shares<br/>that May<br/>Yet be Purchased<br/>Under the Plans<br/>Or Programs (a)</u> |
|-------------------------|---|---|---|---|
| <u>3rd Quarter 2007</u> |   |   |   |   |
| July                    | -   | -   | -   | -   |
| August                  | 3,115,100   | \$27.08                                     | 3,115,100   | 6,039,500   |
| September               | 729,100   | \$27.97                                     | 729,100   | 5,310,400   |

(a) Represents the remaining shares that may be repurchased under the Plans authorized by AFG's Board of Directors in 2004 and 2007.

PART II

OTHER INFORMATION - CONTINUED

ITEM 6

Exhibits

| <u>Number</u> | <u>Exhibit Description</u>  |
|---------------|---|
| <u>10(a)</u>  | First Supplemental Indenture among American Financial Group, Inc., AAG Holding Company, Inc., and U.S. Bank National Association, as trustee, with respect to the 7.35% Subordinated Debentures due 2033.   |
| <u>10(b)</u>  | Third Supplement Indenture among American Financial Group, Inc., AAG Holding Company, Inc., and U.S. Bank National Association, (formerly known as Star Bank, N.A.) as trustee, with respect to the 6-7/8% Senior Notes due December 1, 2008, 7-1/2% Senior Note due November 5, 2033 and 7-1/4% Senior Notes due January 23, 2034. |
| <u>12</u>     | Computation of ratios of earnings to fixed charges.   |
| <u>31(a)</u>  | Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.   |
| <u>31(b)</u>  | Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.   |
| <u>31(c)</u>  | Certification of the Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.  |
| <u>32</u>     | Certification of the Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.   |

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Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, American Financial Group, Inc. has duly caused this Report to be signed on its behalf by the undersigned duly authorized.

American Financial Group, Inc.

November 8, 2007

BY: s/Keith A. Jensen

Keith A. Jensen  
Senior Vice President  
(principal financial and  
accounting officer)  
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