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

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 _X_ No ___

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:
Large Accelerated Filer _X_ Accelerated Filer ___ Non-Accelerated Filer ___

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

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.

AMERICAN FINANCIAL GROUP, INC.

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PART I

ITEM I - FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (unaudited)

(Dollars In Millions)

	September 30, 2007	December 31, 2006
Assets:		
Cash and cash equivalents	$ 729.2	$ 1,329.0
Investments:		
Fixed maturities:		
Available for sale - at fair value		
(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		
(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	285.7	248.3

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
Goodwill	204.5	167.8
	$26,115.9	$25,101.1
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	1,422.1	1,398.9
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	(.1)	55.5
Total shareholders' equity	3,012.9	2,928.9
	$26,115.9	$25,101.1

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EARNINGS (unaudited)

(In Millions, Except Per Share Data)

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
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	86.1	83.2	260.8	234.9
	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	115.9	115.1	408.5	337.0
	1,011.0	979.2	2,875.1	2,653.9
Operating earnings before income taxes	183.8	157.3	491.2	473.7
Provision for income taxes	62.9	56.5	172.0	157.8
Net operating earnings	120.9	100.8	319.2	315.9
Minority interest expense	(7.8)	(6.7)	(26.4)	(21.7)

Equity in net losses of investee, net of tax	(.4)	(.6)	(1.2)	(1.6)
Earnings from continuing operations	112.7	93.5	291.6	292.6
Discontinued operations, net of tax	-	-	1.7	25.3
Net Earnings	$ 112.7	$ 93.5	$ 293.3	$ 317.9
Basic earnings per Common Share:				
Continuing operations	$ .96	$ .79	$2.46	$2.49
Discontinued operations	-	-	.01	.21
Net earnings available to Common Shares	$ .96	$ .79	$2.47	$2.70
Diluted earnings per Common Share:				
Continuing operations	$ .93	$ .77	$2.39	$2.43
Discontinued operations	-	-	.01	.21
Net earnings available to Common Shares	$ .93	$ .77	$2.40	$2.64
Average number of Common Shares:				
Basic	117.6	118.1	118.9	117.8
Diluted	119.8	120.6	121.6	120.1
Cash dividends per Common Share	$.10	$.092	$.30	$.275

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (unaudited)

(Dollars in Millions)

	Common Stock	Accumulated Other

	Common Shares	and Capital Surplus	Retained Earnings	Comprehensive Income (Loss)	Total
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) on securities	-	-	-	(71.1)	(71.1)
Change in foreign currency translation	-	-	-	20.6	20.6
Change in unrealized pension and other postretirement benefits	-	-	-	2.9	2.9
Total comprehensive income					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	-	(1.1	-	-	(1.1
	)			)	
Balance at September 30, 2007	115,530,808	$1,317.6	1,695.4	($ .1)	$3,012.9

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)	(30.7
				)	
Total comprehensive income					287.2

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	-	4.6	-	-	4.6
Balance at September 30, 2006	118,673,136	$1,324.3	$1,415.8	$ 20.1	$2,760.2

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

	Nine months ended September 30,	
	2007	2006
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

Increase in payable to reinsurers	96.6	181.0
Increase (decrease) in other liabilities	10.3	(6.8)
Other, net	11.0	17.4
Net cash provided by operating activities	621.0	797.7
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	(108.5	(38.7
	)	)
Net cash used in investing activities	(1,234.0	(231.6
	)	)
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	2.0	(.6
		)
Net cash provided by financing activities	13.2	101.9

Net Increase (Decrease) in Cash and Cash Equivalents	(599.8)	668.0
Cash and cash equivalents at beginning of period	1,329.0	471.8
Cash and cash equivalents at end of period	$ 729.2	$1,139.8

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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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

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):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Adjustments to net earnings:				

Dilution of majority-owned subsidiaries	($0.1)	($0.4)	($1.0)	($0.9)
Assumed issuance of shares under				
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.

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

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.

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 September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenues				

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	.2	.4	.5	1.5
	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	50.3	45.9	149.6	143.8
	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	33.1	33.0	92.0	79.3
	293.7	273.6	890.9	773.1
Other	8.3	4.9	29.6	16.5
	$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

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)	(3.0)	(1.4)	(48.1)	(6.4)
	101.8	80.8	274.7	222.5
Investment income, realized gains and other	74.7	70.9	231.5	244.0
	176.5	151.7	506.2	466.5
Annuity and supplemental insurance	23.3	30.8	89.4	78.9
Other (c)	(16.0)	(25.2)	(104.4)	(71.7)
	$ 183.8	$ 157.3	$ 491.2	$ 473.7

(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.

D.

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, 2007	December 31, 2006
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	3.7	3.8
	541.0	550.9
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 Notes due May 2011	8.0	8.1
Other	2.3	6.9
	321.2	313.1
Payable to Subsidiary Trusts:		
AAG Holding 7.35% Subordinated Debentures due May 2033	20.0	20.0
AAG Holding 8-7/8% Subordinated Debentures	-	22.0

National Interstate Variable Rate Subordinated Debentures due May 2033	15.0	15.0
	35.0	57.0
	$897.2	$921.0

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, 2007	December 31, 2006
Unsecured obligations	$829.6	$853.2
Obligations secured by real estate	67.6	67.8
	$897.2	$921.0

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, 2007	December 31, 2006
Net unrealized gain (loss) on securities	($29.1)	$50.7
Foreign currency translation adjustment	24.9	4.3
Unrealized pension and other postretirement benefits	4.1	.5
Total accumulated other comprehensive income (loss)	($ .1)	$55.5

Stock Incentive Plans

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.

I.

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.

J.

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

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

September 30, 2007	AFG	GAFRI	AAG Holding	All Other Subs	Cons Entries	Consolidated
Assets:						
Cash and investments	$ 51.4	$ 23.0	$ .4	$17,980.1	($ 1.8)	$18,053.1
Recoverables from reinsurers and prepaid reinsurance premiums	-	-	-	3,703.5	-	3,703.5
Agents' balances and premiums 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 affiliates	3,696.4	1,108.0	1,235.4	1,868.8	(7,908.6)	-
	$3,760.4	$1,152.9	$1,242.5	$27,855.0	($7,894.9)	$26,115.9
Liabilities and Capital:						
Unpaid losses, loss adjustment expenses and unearned premiums	$ -	$ -	$ -	$ 8,108.8	$ -	$ 8,108.8
Annuity, life, accident and health 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	206.5	316.3	110.8	2,284.2	(271.5)	2,646.3
	747.5	317.1	446.2	21,941.0	(348.8)	23,103.0
Total shareholders' equity	3,012.9	835.8	796.3	5,914.0	(7,546.1)	3,012.9
	$3,760.4	$1,152.9	$1,242.5	$27,855.0	($7,894.9)	$26,115.9

December 31, 2006

Assets:						
Cash and investments	$ 223.6	$ 16.9	$ -	$17,501.8	($ 3.3)	$17,739.0
Recoverables from reinsurers and prepaid reinsurance premiums	-	-	-	3,625.2	-	3,625.2
Agents' balances and premiums 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 affiliates	3,412.0	1,113.3	1,256.8	1,824.4	(7,606.5)	-
	$3,648.3	$1,154.9	$1,262.6	$26,594.8	($7,559.5)	$25,101.1
Liabilities and Capital:						
Unpaid losses, loss adjustment expenses and unearned premiums	$ -	$ -	$ -	$ 7,681.6	$ -	$ 7,681.6
Annuity, life, accident and health 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	168.5	80.1	112.8	2,115.6	221.2	2,698.2
	719.4	80.9	509.6	20,770.5	91.8	22,172.2
Total shareholders' equity	2,928.9	1,074.0	753.0	5,824.3	(7,651.3)	2,928.9
	$3,648.3	$1,154.9	$1,262.6	$26,594.8	($7,559.5)	$25,101.1

CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2007	AFG	GAFRI	AAG Holding	All Other Subs	Cons Entries	Consolidated
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	194.9	21.9	26.2	10.0	(253.0)	-
	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	5.8	2.8	1.1	112.7	1.9	124.3
	25.0	3.0	9.9	994.1	(12.6)	1,019.4
Earnings before income taxes	175.4	22.6	16.3	216.4	(255.3)	175.4
Provision for income taxes	62.7	6.1	1.8	66.3	(74.2)	62.7
Net Earnings	$112.7	$16.5	$ 14.5	$ 150.1	($181.1)	$ 112.7

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	540.0	83.0	106.9	36.8	(766.7)	-
	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	30.0	9.4	2.9	385.5	9.0	436.8
	86.9	9.7	30.5	2,810.5	(34.2)	2,903.4
Earnings before income taxes	462.9	87.0	73.0	612.4	(772.4)	462.9
Provision for income taxes	171.3	27.6	21.1	196.7	(245.4)	171.3
Income from continuing operations	291.6	59.4	51.9	415.7	(527.0)	291.6
Discontinued operations, net of tax	1.7	1.9	-	1.9	(3.8)	1.7
Net Earnings	$293.3	$61.3	$ 51.9	$ 417.6	($530.8)	$ 293.3

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006	AFG	GAFRI	AAG Holding	All Other Subs	Cons Entries	Consolidated
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	174.9	25.0	34.5	15.4	(249.8)	-
	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	12.3	2.5	2.4	102.3	3.3	122.8
	25.9	2.6	12.6	952.2	(6.4)	986.9
Earnings before income taxes	149.6	30.5	21.8	201.5	(253.8)	149.6
Provision for income taxes	56.1	10.7	7.6	68.6	(86.9)	56.1

Net Earnings	$ 93.5	$19.8	$ 14.2	$ 132.9