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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, 2001**

**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 ☐

As of November 1, 2001, there were 68,305,711 shares of the Registrant's Common Stock outstanding, excluding 18,666,614 shares owned by subsidiaries.

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

**PART I**

**FINANCIAL INFORMATION**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEET**

(Dollars In Thousands)

	September 30, 2001	December 31, 2000
<b>Assets:</b>		
Cash and short-term investments	\$ 489,584	\$ 438,670
Investments:		
Fixed maturities - at market (amortized cost - \$10,578,281 and \$10,148,348)	10,914,781	10,164,648
Other stocks - at market (cost - \$185,890 and \$174,959)	304,990	385,359
Investment in investee corporations	-	23,996
Policy loans	214,797	213,469
Real estate and other investments	231,696	273,994
Total investments	<u>11,666,264</u>	<u>11,061,466</u>
Recoverables from reinsurers and prepaid reinsurance premiums	2,247,868	1,845,171
Agents' balances and premiums receivable	738,456	700,215
Deferred acquisition costs	802,290	763,097
Other receivables	297,287	240,731
Variable annuity assets (separate accounts)	453,780	533,655
Prepaid expenses, deferred charges and other assets	538,281	513,616
Cost in excess of net assets acquired	<u>316,098</u>	<u>318,920</u>
	<u><u>\$17,549,908</u></u>	<u><u>\$16,415,541</u></u>
<b>Liabilities and Capital:</b>		
Unpaid losses and loss adjustment expenses	\$ 4,887,388	\$ 4,515,561
Unearned premiums	1,598,200	1,414,492
Annuity benefits accumulated	5,717,539	5,543,683
Life, accident and health reserves	614,708	599,360
Long-term debt:		
Holding companies	612,204	584,869
Subsidiaries	252,110	195,087
Variable annuity liabilities (separate accounts)	453,780	533,655
Accounts payable, accrued expenses and other liabilities	<u>1,372,285</u>	<u>972,271</u>
Total liabilities	15,508,214	14,358,978
Minority interest	458,724	508,033
<b>Shareholders' Equity:</b>		
Common Stock, no par value		
- 200,000,000 shares authorized		
- 68,215,312 and 67,410,091 shares outstanding	68,215	67,410
Capital surplus	910,387	898,244
Retained earnings	345,068	442,276
Unrealized gain on marketable securities, net	259,300	140,600
Total shareholders' equity	<u>1,582,970</u>	<u>1,548,530</u>
	<u><u>\$17,549,908</u></u>	<u><u>\$16,415,541</u></u>

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF OPERATIONS  
(In Thousands, Except Per Share Data)**

	Three months ended September 30,		Nine months ended September 30,	
	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000</u>
<b>Income:</b>				
Property and casualty insurance premiums	\$ 664,381	\$ 661,077	\$1,988,667	\$1,856,935
Life, accident and health premiums	69,116	66,523	208,807	166,146
Investment income	214,439	210,174	638,755	628,489
Realized gains (losses) on:				
Securities	(22)	(15,223)	(33,328)	(20,563)
Subsidiaries	7,065	(5,962)	5,479	19,038
Other investments	-	27,230	-	27,230
Other income	59,857	68,777	171,945	178,596
	<u>1,014,836</u>	<u>1,012,596</u>	<u>2,980,325</u>	<u>2,855,871</u>
<b>Costs and Expenses:</b>				
Property and casualty insurance:				
Losses and loss adjustment expenses	626,642	562,308	1,649,269	1,463,456
Commissions and other underwriting expenses	189,327	195,267	567,203	556,272
Annuity benefits	74,016	72,139	213,996	218,027
Life, accident and health benefits	53,952	50,699	160,246	124,308
Interest charges on borrowed money	14,924	18,182	45,883	51,007
Other operating and general expenses	118,404	113,362	345,187	344,092
	<u>1,077,265</u>	<u>1,011,957</u>	<u>2,981,784</u>	<u>2,757,162</u>
Operating earnings (loss) before income taxes	(62,429)	639	(1,459)	98,709
Provision (credit) for income taxes	<u>(22,152)</u>	<u>(1,595)</u>	<u>(4,547)</u>	<u>28,767</u>
Net operating earnings (loss)	(40,277)	2,234	3,088	69,942
Minority interest expense, net of tax	(9,028)	(10,839)	(27,346)	(26,699)
Equity in net losses of investees, net of tax	<u>(6,395)</u>	<u>(13,570)</u>	<u>(12,042)</u>	<u>(4,368)</u>
Earnings (loss) before cumulative effect of accounting change	(55,700)	(22,175)	(36,300)	38,875
Cumulative effect of accounting change	<u>-</u>	<u>-</u>	<u>(10,040)</u>	<u>-</u>
<b>Net Earnings (Loss)</b>	<u>(\$ 55,700)</u>	<u>(\$ 22,175)</u>	<u>(\$ 46,340)</u>	<u>\$ 38,875</u>
<b>Earnings (Loss) per Common Share:</b>				
Basic	(\$ .82)	(\$ .38)	(\$ .68)	\$.66
Diluted	(\$ .81)	(\$ .38)	(\$ .67)	\$.66
<b>Average number of Common Shares:</b>				
Basic	68,028	58,561	67,799	58,525
Diluted	68,494	58,797	68,312	58,731
Cash dividends per Common Share	\$.25	\$.25	\$.75	\$.75

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
(Dollars in Thousands)**

	Common Shares	Common Stock and Capital Surplus	Retained Earnings	Unrealized Gain (Loss) on Securities	Total
<b>Balance at January 1, 2001</b>	<u>67,410,091</u>	<u>\$965,654</u>	<u>\$442,276</u>	<u>\$140,600</u>	<u>\$1,548,530</u>
Net earnings (loss)	-	-	(46,340)	-	(46,340)
Change in unrealized Comprehensive income	-	-	-	118,700	<u>118,700</u>
					72,360
Dividends on Common Stock	-	-	(50,819)	-	(50,819)
Shares issued:					
Exercise of stock options	54,435	1,289	-	-	1,289
Employee stock purchase plan	39,642	1,046	-	-	1,046
Retirement plan contributions	711,477	17,007	-	-	17,007
Directors fees paid in stock	2,874	72	-	-	72
Shares acquired and retired	(3,538)	(51)	(49)	-	(100)
Tax effect of intercompany dividends	-	(4,800)	-	-	(4,800)
Capital transactions of subsidiaries	-	(375)	-	-	(375)
Other	<u>331</u>	<u>(1,240)</u>	<u>-</u>	<u>-</u>	<u>(1,240)</u>
<b>Balance at September 30, 2001</b>	<u>68,215,312</u>	<u>\$978,602</u>	<u>\$345,068</u>	<u>\$259,300</u>	<u>\$1,582,970</u>
<b>Balance at January 1, 2000</b>	<u>58,419,952</u>	<u>\$800,640</u>	<u>\$557,538</u>	<u>(\$ 18,200)</u>	<u>\$1,339,978</u>
Net earnings	-	-	38,875	-	38,875
Change in unrealized Comprehensive income	-	-	-	7,100	<u>7,100</u>
					45,975
Dividends on Common Stock	-	-	(43,880)	-	(43,880)
Shares issued:					
Exercise of stock options	39,319	831	-	-	831
Dividend reinvestment plan	3,910	92	-	-	92
Employee stock purchase plan	54,738	1,356	-	-	1,356
Retirement plan contributions	274,716	6,242	-	-	6,242
Directors fees paid in stock	2,820	72	-	-	72
Shares acquired and retired	(41,044)	(562)	(579)	-	(1,141)
Tax effect of intercompany dividends	-	(4,800)	-	-	(4,800)
Capital transactions of subsidiaries	-	178	-	-	178
Other	<u>-</u>	<u>1,755</u>	<u>-</u>	<u>-</u>	<u>1,755</u>
<b>Balance at September 30, 2000</b>	<u>58,754,411</u>	<u>\$805,804</u>	<u>\$551,954</u>	<u>(\$ 11,100)</u>	<u>\$1,346,658</u>

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(In Thousands)**

	Nine months ended September 30,	
	<u>2001</u>	<u>2000</u>
<b>Operating Activities:</b>		
Net earnings (loss)	(\$ 46,340)	\$ 38,875
Adjustments:		
Cumulative effect of accounting change	10,040	-
Equity in net losses of investees	12,042	4,368
Depreciation and amortization	111,608	94,379
Annuity benefits	213,996	218,027
Realized (gains) losses on investing activities	1,106	(40,246)
Deferred annuity and life policy acquisition costs	(111,377)	(106,844)
Increase in reinsurance and other receivables	(382,233)	(57,172)
Increase in other assets	(32,858)	(63,973)
Increase in insurance claims and reserves	589,761	286,781
Increase (decrease) in other liabilities	176,933	(4,798)
Increase in minority interest	9,509	2,879
Other, net	16,173	13,330
	<u>568,360</u>	<u>385,606</u>
<b>Investing Activities:</b>		
Purchases of and additional investments in:		
Fixed maturity investments	(1,609,151)	(1,237,409)
Equity securities	(5,556)	(22,547)
Real estate, property and equipment	(43,660)	(57,238)
Maturities and redemptions of fixed maturity investments	579,916	465,637
Sales of:		
Fixed maturity investments	666,593	651,578
Equity securities	11,978	67,473
Subsidiaries	40,395	35,000
Real estate, property and equipment	46,683	8,156
Cash and short-term investments of acquired (former) subsidiaries	(134,237)	(131,880)
Decrease (increase) in other investments	(4,711)	8,695
	<u>(451,750)</u>	<u>(212,535)</u>
<b>Financing Activities:</b>		
Fixed annuity receipts	454,189	359,884
Annuity surrenders, benefits and withdrawals	(482,997)	(564,454)
Net transfers from (to) variable annuity assets	3,252	(44,305)
Additional long-term borrowings	185,668	131,341
Reductions of long-term debt	(102,067)	(133,343)
Issuances of Common Stock	2,078	1,890
Repurchases of trust preferred securities	(75,000)	(2,479)
Cash dividends paid	(50,819)	(43,788)
	<u>(65,696)</u>	<u>(295,254)</u>
<b>Net Increase (Decrease) in Cash and Short-term Investments</b>	50,914	(122,183)
Cash and short-term investments at beginning of period	<u>438,670</u>	<u>390,630</u>
Cash and short-term investments at end of period	<u>\$ 489,584</u>	<u>\$ 268,447</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**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 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.

**Investments** All fixed maturity securities are considered "available for sale" and reported at fair value with unrealized gains and losses reported as a separate component of shareholders' equity. Short-term investments are carried at cost; loans receivable are carried primarily at the aggregate unpaid balance. Premiums and discounts on mortgage-backed securities are amortized over a period based on estimated future principal prepayments and adjusted to reflect actual prepayments.

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, a provision for impairment is charged to earnings and the carrying value of that investment is reduced.

Emerging Issues Task Force Issue No. 99-20 established a new standard for recognizing impairment of certain asset-backed investments. Impairment losses on these investments must be recognized when (i) the fair value of the security is less than its carrying value and (ii) there has been an adverse change in the expected cash flows. The new standard became effective on April 1, 2001. Impairment losses on initial application of this rule were recognized as the cumulative effect of an accounting change. Subsequent impairments are recognized as a component of net realized gains and losses.

**Investment in Investee Corporations** Investments in securities of 20%- to 50%-owned companies are generally carried at cost, adjusted for AFG's proportionate share of their undistributed earnings or losses.

Due to Chiquita's announced intention to pursue a plan to restructure its public debt, AFG wrote down its investment in Chiquita common stock to market value at December 31, 2000. In 2001, AFG suspended accounting for the investment under the equity method due to the expected restructuring, and reclassified the investment to "Other stocks."

**Cost in Excess of Net Assets Acquired** The excess of cost of subsidiaries over AFG's equity in the underlying net assets ("goodwill") is being amortized over periods of 20 to 40 years.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**Insurance** As discussed under "Reinsurance" below, unpaid losses and loss adjustment expenses and unearned premiums have not been reduced for reinsurance recoverable. To the extent that unrealized gains (losses) from securities classified as "available for sale" would result in adjustments to deferred acquisition costs and policyholder liabilities had those gains (losses) actually been realized, such balance sheet amounts are adjusted, net of deferred taxes.

**Reinsurance** In the normal course of business, AFG's insurance subsidiaries cede reinsurance to other companies to diversify risk and limit maximum loss arising from large claims. To the extent that any reinsuring companies are unable to meet obligations under agreements covering reinsurance ceded, AFG's insurance subsidiaries would remain liable. Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG's insurance subsidiaries report as assets (a) the estimated reinsurance recoverable on 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. AFG's insurance subsidiaries also assume reinsurance from other companies. Income on reinsurance assumed is recognized based on reports received from ceding companies.

**Deferred Acquisition Costs** Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred ("DPAC"). 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. DPAC related to annuities and universal life insurance products is amortized, with interest, in relation to the present value of expected gross profits on the policies. 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.

**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 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. These 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 Operations in the period in which determined. In spite of 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 anticipated investment yield, 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**Variable Annuity Assets and Liabilities** Separate accounts related to variable annuities represent deposits invested in underlying investment funds on which Great American Financial Resources, Inc. ("GAFRI"), an 83%-owned subsidiary, earns a fee. Investment funds are selected and may be changed only by the policyholder.

**Premium Recognition** Property and casualty premiums are earned 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.

**Policyholder Dividends** Dividends payable to policyholders are included in "Accounts payable, accrued expenses and other liabilities" and represent estimates of amounts payable on participating policies which share in favorable underwriting results. Estimates are accrued during the period in which premiums are earned. Changes in estimates are included in income in the period determined. Policyholder dividends do not become legal liabilities unless and until declared by the boards of directors of the insurance companies.

**Minority Interest** For balance sheet purposes, minority interest represents the interests of noncontrolling shareholders in AFG subsidiaries, including American Financial Corporation ("AFC") preferred stock and preferred securities issued by trust subsidiaries of AFG. For income statement purposes, minority interest expense represents those shareholders' interest in the earnings of AFG subsidiaries as well as AFC preferred dividends and accrued distributions on the trust preferred securities.

**Income Taxes** AFC files consolidated federal income tax returns which include all 80%-owned U.S. subsidiaries, except for certain life insurance subsidiaries and their subsidiaries. Because holders of AFC Preferred Stock hold in excess of 20% of AFC's voting rights, AFG (parent) and its direct subsidiary, AFC Holding Company ("AFC Holding" or "AFCH"), are not eligible to file consolidated returns with AFC, and therefore, file separately.

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.

**Stock-Based Compensation** As permitted under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," AFG accounts for stock options and other stock-based compensation plans using the intrinsic value based method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees."

**Benefit Plans** AFG provides retirement benefits to qualified employees of participating companies through contributory and noncontributory defined contribution plans contained in AFG's Retirement and Savings Plan. Under the retirement portion of the plan, company contributions are invested primarily in



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

securities of AFG and affiliates. Under the savings portion of the plan, AFG matches a specific portion of employee contributions. Contributions to benefit plans are charged against earnings 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.

**Derivatives** Effective October 1, 2000, AFG implemented SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", which establishes accounting and reporting standards for derivative instruments (including derivative instruments that are embedded in other contracts) and for hedging activities. Prior year financial statements were not restated. SFAS No. 133 generally requires that derivatives (both assets and liabilities) be recognized in the balance sheet at fair value with changes in fair value included in current earnings.

Derivatives included in AFG's Balance Sheet consist primarily of investments in common stock warrants (included in other stocks), the equity-based component of certain annuity products (included in annuity benefits accumulated) and call options (included in other investments) used to mitigate the risk embedded in the equity-indexed annuity products.

**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 the following dilutive effect of common stock options: third quarter of 2001 and 2000 - 466,000 shares and 236,000 shares; nine months of 2001 and 2000 - 513,000 shares and 206,000 shares, respectively.

**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. Sale of Subsidiaries**

**Seven Hills Insurance Company** In July 2001, AFG sold Seven Hills Insurance Company for \$18.4 million, realizing a pretax gain of \$7.1 million. As a part of the sale, AFG assumed all liability for Seven Hills' business prior to the date of the sale.

**Japanese division** In December 2000, AFG agreed to sell its Japanese property and casualty division to Mitsui Marine & Fire Insurance Company of America for \$22 million in cash and recorded a \$10.7 million pretax loss on the sale. Upon completion of the sale in March 2001, AFG realized an additional pretax loss of \$1.6 million and deferred a gain of approximately \$21 million on ceded insurance which is being recognized over the estimated settlement period (weighted average of 4 years) of the ceded claims. At the same time, a reinsurance agreement under which Great American Insurance ceded a portion of its pool of insurance to

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Mitsui was terminated. The Japanese division generated net written premiums of approximately \$60 million per year to Great American while Great American ceded approximately \$45 million per year to Mitsui.

**Stonewall Insurance Company** In September 2000, AFG sold Stonewall Insurance Company, realizing a pretax loss of \$6 million. AFG recognized an additional pretax loss of \$4.3 million in the fourth quarter of 2000 as a result of post-closing adjustments. Stonewall was a non-operating property and casualty subsidiary with approximately \$320 million in assets, engaged primarily in the run-off of approximately \$170 million in asbestos and environmental liabilities associated with policies written through 1991.

**Commercial lines division** In 1998, AFG sold its Commercial lines division to Ohio Casualty Corporation. In August 2000, AFG received an additional payment of \$25 million from Ohio Casualty based on retention and growth through May 2000 of the businesses sold. This earn-out was recognized as additional "gain on sale of subsidiary" in the second quarter of 2000.

- C. **Segments of Operations** AFG's property and casualty group is engaged primarily in private passenger automobile and specialty insurance businesses. The Specialty group includes a highly diversified group of specialty business units. Some of the more significant areas are inland and ocean marine, California workers' compensation, agricultural-related coverages, executive and professional liability, fidelity and surety bonds, collateral protection, and umbrella and excess coverages. The Personal group writes nonstandard and preferred/standard private passenger auto and other personal insurance coverage. AFG's annuity, life and health business markets primarily retirement products as well as life and supplemental health insurance.

**AMERICAN FINANCIAL GROUP, INC. 10-Q**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

The following table (in thousands) shows AFG's revenues and operating profit (loss) by significant business segment. Operating profit (loss) represents total revenues less operating expenses.

	Three months ended September 30,		Nine months ended September 30,	
	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000</u>
<b>Revenues (a)</b>				
Property and casualty insurance:				
Premiums earned:				
Specialty	\$ 390,254	\$ 334,846	\$1,062,749	\$ 917,057
Personal	273,905	326,591	924,166	940,237
Other lines - primarily discontinued	222	(360)	1,752	(359)
	<u>664,381</u>	<u>661,077</u>	<u>1,988,667</u>	<u>1,856,935</u>
Investment and other income	117,233	98,703	331,008	349,181
	<u>781,614</u>	<u>759,780</u>	<u>2,319,675</u>	<u>2,206,116</u>
Annuities, life and health (b)	228,044	235,862	647,636	619,144
Other	5,178	16,954	13,014	30,611
	<u>\$1,014,836</u>	<u>\$1,012,596</u>	<u>\$2,980,325</u>	<u>\$2,855,871</u>
<b>Operating Profit (Loss)</b>				
Property and casualty insurance:				
Underwriting:				
Specialty	(\$ 32,119)	(\$ 56,580)	(\$ 38,958)	(\$ 81,758)
Personal	(21,104)	(34,704)	(84,681)	(72,029)
Other lines (c)	(98,365)	(5,214)	(104,166)	(9,006)
	<u>(151,588)</u>	<u>(96,498)</u>	<u>(227,805)</u>	<u>(162,793)</u>
Investment and other income	73,115	57,450	217,464	235,457
	<u>(78,473)</u>	<u>(39,048)</u>	<u>(10,341)</u>	<u>72,664</u>
Annuities, life and health	36,959	50,501	84,417	75,806
Other (d)	(20,915)	(10,814)	(75,535)	(49,761)
	<u>(\$ 62,429)</u>	<u>\$ 639</u>	<u>(\$ 1,459)</u>	<u>\$ 98,709</u>

- (a) Revenues include sales of products and services as well as other income earned by the respective segments.
- (b) Represents primarily investment income.
- (c) Represents primarily losses related to asbestos and other environmental matters ("A&E")
- (d) Includes holding company expenses.

**D. Investee Corporations** Investment in investee corporations at December 31, 2000, reflects AFG's ownership of 24 million shares (33%) of Chiquita common stock. The market value of this investment was \$24 million at December 31, 2000. Chiquita is a leading international marketer, producer and distributor of quality fresh fruits and vegetables and processed foods. Summarized financial information for Chiquita for the nine months ended September 30, 2000, follows (in millions):

Net Sales	\$1,725
Operating Income	88
Net Loss	(6)

In January 2001, Chiquita announced a restructuring initiative that included discontinuing all interest and principal payments on its public debt. A restructuring is expected to result in the conversion of a significant portion of Chiquita's \$862 million in public debt into common equity. Although the expected restructuring would not impact Chiquita's day-to-day operations, it would adversely affect the holders of its stock, including AFG.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**Start-up manufacturing businesses** Since 1998, AFG subsidiaries have made loans to two start-up manufacturing businesses which were previously owned by unrelated third-parties. During 2000, the former owners chose to forfeit their equity interests to AFG rather than invest additional capital. In the fourth quarter of 2000, AFG sold the equity interests to a group of employees for nominal cash consideration plus warrants to repurchase a significant ownership interest. Due to the absence of significant financial investment by the buyers relative to the amount of debt owed to AFG subsidiaries, the sale was not recognized as a divestiture for accounting purposes. Assets of the businesses transferred (approximately \$55 million at September 30, 2001 and December 31, 2000) are included in other assets; liabilities of the businesses transferred (approximately \$9 million at September 30, 2001 and \$7 million at December 31, 2000, after elimination of loans from AFG subsidiaries) are included in other liabilities. AFG's equity in the losses of these two companies (\$6.4 million in the third quarter and \$12.0 million in the first nine months of 2001) is included in investee losses in the Statement of Operations. One of the businesses is involved in litigation impacting its operations; see "Investee Corporations" in Management's Discussion and Analysis.

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

	September 30, 2001	December 31, 2000
<b>Holding Companies:</b>		
AFG 7-1/8% Senior Debentures due April 2009	\$301,064	\$300,931
AFG 7-1/8% Senior Debentures due December 2007	79,600	79,600
AFC notes payable under bank line	206,000	178,000
APU 10-7/8% Subordinated Notes due May 2011	11,570	11,611
Other	13,970	14,727
	<u>\$612,204</u>	<u>\$584,869</u>
<b>Subsidiaries:</b>		
GAFRI 6-7/8% Senior Notes due June 2008	\$100,000	\$100,000
GAFRI notes payable under bank line	121,100	48,500
Notes payable secured by real estate	16,500	31,201
Other	14,510	15,386
	<u>\$252,110</u>	<u>\$195,087</u>

At September 30, 2001, sinking fund and other scheduled principal payments on debt for the balance of 2001 and the subsequent five years were as follows (in millions):

	Holding Companies	Subsidiaries	Total
2001	\$ .5	\$ .3	\$ .8
2002	216.5	1.3	217.8
2003	-	1.3	1.3
2004	-	122.1	122.1
2005	-	10.0	10.0
2006	-	.7	.7

Debentures purchased in excess of scheduled payments may be applied to satisfy any sinking fund requirement. The scheduled principal payments shown above assume that debentures previously purchased are applied to the earliest scheduled retirements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

AFC and GAFRI each have an unsecured credit agreement with a group of banks under which they can borrow up to \$300 million and \$155 million, respectively. Borrowings bear interest at floating rates based on prime or Eurodollar rates. Loans mature in December 2002 under the AFC credit agreement and in December 2004 under the GAFRI credit agreement.

- F. **Minority Interest** Minority interest in AFG's balance sheet is comprised of the following (in thousands):

	September 30, 2001	December 31, 2000
Interest of noncontrolling shareholders in subsidiaries' common stock	\$144,907	\$119,216
Preferred securities issued by subsidiary trusts	241,663	316,663
AFC preferred stock	<u>72,154</u>	<u>72,154</u>
	<u>\$458,724</u>	<u>\$508,033</u>

**Preferred Securities** Wholly-owned subsidiary trusts of AFG and GAFRI have issued preferred securities and, in turn, purchased a like amount of subordinated debt which provides interest and principal payments to fund the respective trusts' obligations. The preferred securities must be redeemed upon maturity or redemption of the subordinated debt. AFG and GAFRI effectively provide unconditional guarantees of their respective trusts' obligations.

The preferred securities consisted of the following (in thousands):

Date of Issuance	Issue (Maturity Date)	September 30, 2001	December 31, 2000	Optional Redemption Dates
October 1996	AFCH 9-1/8% TOPrS (2026)	\$98,750	\$98,750	On or after 10/22/2001
November 1996	GAFRI 9-1/4% TOPrS (2026)	72,913	72,913	On or after 11/7/2001
March 1997	GAFRI 8-7/8% Pfd (2027)	70,000	70,000	On or after 3/1/2007
May 1997	GAFRI 7-1/4% ROPES (2041)	-	75,000	

On September 28, 2001, GAFRI redeemed its ROPES for \$75 million in cash.

**AFC Preferred Stock** AFC's Preferred Stock is voting, cumulative, and consists of the following:

**Series J**, no par value; \$25.00 liquidating value per share; annual dividends per share \$2.00; redeemable at AFC's option at \$25.75 per share beginning December 2005 declining to \$25.00 at December 2007 and thereafter; 2,886,161 shares (stated value \$72.2 million) outstanding.

**Minority Interest Expense** Minority interest expense is comprised of (in thousands):

	Nine months ended September 30,	
	2001	2000
Interest of noncontrolling shareholders in earnings of subsidiaries	\$ 9,656	\$ 9,011
Accrued distributions by subsidiaries on preferred securities:		
Trust issued securities, net of tax	13,361	13,359
AFC preferred stock	<u>4,329</u>	<u>4,329</u>
	<u>\$27,346</u>	<u>\$26,699</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

- G. **Shareholders' Equity** At September 30, 2001, there were 68,215,312 shares of AFG Common Stock outstanding, including 1,362,935 shares held by American Premier for possible distribution to certain creditors and other claimants upon proper claim presentation and settlement pursuant to the 1978 plan of reorganization of American Premier's predecessor, The Penn Central Corporation. Shares being held for distribution are not eligible to vote but otherwise are accounted for as issued and outstanding. 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.

At September 30, 2001, there were 9.7 million shares of AFG Common Stock reserved for issuance upon exercise of stock options. As of that date, options for 6.2 million shares were outstanding. Options generally become exercisable at the rate of 20% per year commencing one year after grant; those granted to non-employee directors of AFG are fully exercisable upon grant. All options expire ten years after the date of grant.

The change in unrealized gain (loss) on marketable securities for the nine months ended September 30 included the following (in millions):

	<u>Pretax</u>	<u>Taxes</u>	<u>Minority Interest</u>	<u>Net</u>
<u>2001</u>				
Unrealized holding gains on securities arising during the period	\$175.4	(\$60.9)	(\$15.7)	\$ 98.8
Realized losses included in net income and unrealized gains of subsidiary sold	<u>33.1</u>	<u>(11.6)</u>	<u>(1.6)</u>	<u>19.9</u>
Change in unrealized gain on marketable securities, net	<u>\$208.5</u>	<u>(\$72.5)</u>	<u>(\$17.3)</u>	<u>\$118.7</u>
<u>2000</u>				
Unrealized holding losses on securities arising during the period	(\$ 9.9)	\$ 4.3	(\$2.3)	(\$ 7.9)
Realized losses included in net income and unrealized losses of subsidiary sold	<u>25.2</u>	<u>(8.8)</u>	<u>(1.4)</u>	<u>15.0</u>
Change in unrealized gain (loss) on marketable securities, net	<u>\$15.3</u>	<u>(\$ 4.5)</u>	<u>(\$3.7)</u>	<u>\$ 7.1</u>

- H. **Commitments and Contingencies** There have been no significant changes to the matters discussed and referred to in Note L "Commitments and Contingencies" of AFG's Annual Report on Form 10-K for 2000.

ITEM 2

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

**GENERAL**

AFG and its subsidiaries, AFC Holding, AFC and American Premier, are organized as holding companies with almost all of their operations being conducted by subsidiaries. These parent corporations, however, have 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, since 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.

**IT Initiative** In 1999, AFG initiated an enterprise-wide project to study its information technology ("IT") resources, needs and opportunities. The initiative, involving improvements in physical infrastructure and business support systems, entails extensive effort and costs over a period of several years. While the costs precede the expected savings, management believes the benefits in efficiencies and effectiveness will exceed the costs incurred, all of which have been and will be funded through available working capital.

**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 forward-looking words such as "believes", "expects", "may", "will", "should", "seeks", "intends", "plans", "estimates", "anticipates" or the negative version of those words or other comparable terminology. 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 legal environment;
- judicial decisions and rulings;
- tax law changes;
- levels of catastrophes and other major losses;
- the actual amount of liabilities associated with certain environmental and asbestos-related insurance claims;
- adequacy of loss reserves;
- availability of reinsurance; and
- competitive pressures, including the ability to obtain rate increases.

Forward-looking statements speak only as of the date made. AFG undertakes no obligations to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.

**LIQUIDITY AND CAPITAL RESOURCES**

**Ratios** AFG's debt to total capital ratio (at the parent holding company level) was approximately 26% at September 30, 2001 and 25% at December 31, 2000. AFG's ratio of earnings to fixed charges (on a total enterprise basis) was .68 for the first nine months of 2001 and 1.63 for the entire year of 2000. Due primarily

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

to the \$100 million strengthening of asbestos and environmental reserves in the third quarter, fixed charges exceeded earnings by \$26 million during the first nine months of 2001.

**Sources of Funds** Management believes the parent holding companies have sufficient resources to meet their liquidity requirements, primarily through funds generated by their subsidiaries' operations. If funds provided by subsidiaries through dividends and tax payments are insufficient to meet fixed charges in any period, the holding companies would be required to generate cash through borrowings, sales of securities or other assets, or similar transactions.

AFC has a revolving credit agreement with several banks under which it can borrow up to \$300 million. This credit line provides liquidity and can be used to obtain funds for operating subsidiaries or, if necessary, for the parent companies. At September 30, 2001, there was \$206 million borrowed under the line.

Dividend payments from subsidiaries have been very important to the liquidity and cash flow of the individual holding companies during certain periods in the past. However, the reliance on such dividend payments has been lessened in recent years by the combination of (i) reductions in the amounts and cost of debt at the holding companies from historical levels (and the related decrease in ongoing cash needs for interest and principal payments), (ii) AFG's ability to obtain financing in capital markets, as well as (iii) the sales of certain noncore investments.

**Investments** Approximately 93% of the fixed maturities held by AFG were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies at September 30, 2001. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and noninvestment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

AFG's equity securities are concentrated in a relatively limited number of major positions. This approach allows management to more closely monitor the companies and the industries in which they operate.

## **RESULTS OF OPERATIONS**

**General** Pretax operating losses for the three months and nine months ended September 30, 2001 were \$62.4 million and \$1.5 million, respectively, compared to earnings of \$639,000 and \$98.7 million in the comparable 2000 periods. Results for the third quarter of 2001 include a \$100 million asbestos and environmental charge and losses of \$25 million resulting from the World Trade Center terrorist attack. Results for 2000 include a third quarter charge of \$35 million for reserve strengthening in the California workers' compensation business and special litigation charges of \$41 million recorded in the second quarter. Results for the first nine months of 2001 include realized losses of \$27.8 million compared to gains of \$25.7 million in the comparable 2000 period.

Many investors and analysts focus on "core earnings" of companies, setting aside certain items included in net earnings. Such "core earnings" for AFG, consisting of net earnings adjusted to exclude (i) realized gains (losses), (ii) equity in investee losses, and (iii) the unusual items discussed in the preceding paragraph, were \$27.9 million (\$.41 per share, diluted) and \$73.6 million (\$1.08 per share) in the third quarter and nine months of 2001 compared to \$12 million (\$.21 per share) and \$74 million (\$1.27 per share) in the third quarter and nine months of 2000.



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

**Property and Casualty Insurance - Underwriting** AFG's property and casualty group consists of two major business groups: Specialty and Personal.

The Specialty group includes a highly diversified group of business lines. Some of the more significant areas are inland and ocean marine, California workers' compensation, agricultural-related coverages, executive and professional liability, fidelity and surety bonds, collateral protection, and umbrella and excess coverages.

The Personal group sells nonstandard and preferred/standard private passenger auto insurance and, to a lesser extent, homeowners' insurance. Nonstandard automobile insurance covers risk not typically accepted for standard automobile coverage because of an applicant's driving record, type of vehicle, age or other criteria.

Underwriting profitability is measured by the combined ratio which is a sum of the ratios of underwriting losses, loss adjustment expenses, underwriting expenses and policyholder dividends to premiums. When the combined ratio is under 100%, underwriting results are generally considered profitable; when the ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, other income or federal income taxes.

For certain lines of business and products where the credibility of the range of loss projections is less certain (primarily the various specialty businesses listed above), management believes that it is prudent and appropriate to use conservative assumptions until such time as the data, experience and projections have more credibility, as evidenced by data volume, consistency and maturity of the data. While this practice mitigates the risk of adverse development on this business, it does not eliminate it.

Net written premiums and combined ratios for AFG's property and casualty insurance subsidiaries were as follows (dollars in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2001	2000	2001	2000
<b><u>Net Written Premiums (GAAP)</u></b>				
Specialty	\$417.3	\$341.7	\$1,167.7(a)	\$ 974.9
Personal	190.6	299.4	813.1	997.3
Other lines	-	(.3)	-	(.3)
	<u>\$607.9</u>	<u>\$640.8</u>	<u>\$1,980.8</u>	<u>\$1,971.9</u>
<b><u>Combined Ratios (GAAP) (b)</u></b>				
Specialty (c)	108.3%	116.8%	103.7%	108.9%
Personal	107.7	110.6	109.2	107.6
Aggregate (including discontinued lines) (d)	122.8	114.7	111.4	108.8

(a) Before a reduction of \$29.7 million for unearned premium transfer related to the sale of the Japanese division.

(b) Combined ratios for the entire year of 2000 were: Specialty - 107.9%, Personal - 108.6%, Aggregate - 108.0%.

(c) Includes 6.5% and 2.3% for the three and nine month periods of 2001 relating to the attack on the World Trade Center.

(d) Includes an aggregate of 18.8% and 6.2% for the three and nine month periods of 2001 relating to the A&E charge and the attack on the World Trade Center.

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

**Asbestos and Environmental Reserves Charge** Throughout the property and casualty insurance industry, estimating ultimate liability for asbestos claims has become increasingly uncertain due to inconsistent court decisions, recent bankruptcy filings, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage. The casualty insurance industry as a whole is engaged in extensive litigation over these coverage and liability issues as the volume and severity of claims against asbestos defendants continue to increase.

In October 2001, AFG completed a comprehensive study of its A&E reserves. This study was initiated after experiencing an increase in the number and severity of asbestos claims during the second quarter of 2001 and observing the developments of adverse trends in the property and casualty insurance industry concerning asbestos losses. As a result, AFG recorded a third quarter charge of \$100 million. This charge, accompanied by a transfer of \$36 million from excess reserves for other environmental claims, resulted in an increase of \$136 million in asbestos reserves. At September 30, 2001, A&E reserves were \$554 million (before deducting reinsurance recoverables of \$119 million).

While management believes that the reserves, as strengthened, are a reasonable estimate of ultimate liability for A&E claims, actual results may vary materially from the amount currently recorded due to uncertainties such as insureds seeking bankruptcy protection, predicting the number of future claims, the ability of claimants who exhibit no signs of illness to successfully pursue claims, and the potential for allocation of liability among insurers.

Further, certain policyholders assert that their claims are not subject to aggregate limits on coverage because either their policies failed to contain aggregate limits with respect to products liability coverage or, faced with exhaustion of products coverage limits, their asbestos claims fall within non-products liability coverage which is not subject to any aggregate limit. These claims are now being contested in insurance coverage litigation in various jurisdictions. In rejecting the claims that are the basis of this litigation, AFG believes its coverage defenses are substantial and intends to continue to vigorously defend its position. Nonetheless, such claims may have a material adverse effect upon AFG if resolved unfavorably.

**Specialty** The Specialty group's increase in net written premiums reflects the impact of rate increases implemented in 2000 and 2001 and the realization of growth opportunities in certain commercial markets. Through the first nine months of this year, rate increases in the California worker's compensation business have been in excess of 35% and have averaged over 17% in the other specialty operations. AFG expects these levels of rate increases to continue for the remainder of 2001. The improvement in the combined ratio compared to the 2000 periods reflects the impact of these rate increases. Excluding the effect of the attack on the World Trade Center, the Specialty group's combined ratio improved to 101.8% for the third quarter and 101.4% for the first nine months of 2001.

**Personal** The Personal group's decline in net written premiums reflects a reinsurance agreement, effective April 1, 2001, under which AFG cedes 90% of the automobile physical damage business written by certain of its insurance subsidiaries. This agreement is enabling AFG to reallocate some of its capital to the more profitable specialty operations. Excluding the effect of this agreement, the Personal group's net written premiums declined slightly for the third quarter and nine months as lower business volume was partially offset by the impact of significant rate increases. Through the first nine months of 2001, the group has implemented rate increases of 12%. As a result, the combined ratio improved to 107.7% for the third quarter of 2001.

# AMERICAN FINANCIAL GROUP, INC. 10-Q

## Management's Discussion and Analysis of Financial Condition and Results of Operations - Continued

**Life, Accident and Health Premiums and Benefits** The increase in life, accident and health premiums and benefits for the nine months is due primarily to the acquisition of a block of supplemental health insurance business in 2000.

**Real Estate Operations** AFG's subsidiaries are engaged in a variety of real estate operations including hotels, apartments, office buildings and recreational facilities; 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	
	September 30,		September 30,	
	2001	2000	2001	2000
Other income	\$24.3	\$26.8	\$85.7	\$71.2
Other operating and general expenses	17.9	18.5	49.5	49.8
Interest charges on borrowed money	.3	.6	1.6	1.9
Minority interest expense, net	.2	.7	3.5	1.4

Other income includes net pretax gains on the sale of real estate assets of \$2.0 million in the third quarter and \$26.6 million in the first nine months of 2001 compared to \$.8 million and \$7.5 million for the 2000 periods.

**Other Income** Excluding gains on the sale of real estate assets (discussed above), other income decreased \$25.8 million (15%) in the first nine months of 2001 due primarily to income of \$11.2 million from the sale of certain lease rights in the third quarter of 2000 and income from the sale of operating assets and lease residuals in the first quarter of 2000.

**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.

**Gains (Losses) on Securities** In addition to gains (losses) on sales of securities, provisions for other than temporary impairment of securities still held are included as follows: third quarter of 2001 and 2000 - \$22.9 million and \$6.6 million; nine months of 2001 and 2000 - \$60.1 million and \$9.9 million, respectively. The provisions for the 2001 periods include \$8 million for the writedown of AFG's investment in Chiquita from \$1.00 per share to \$.67 per share.

Under SFAS No. 133, which was adopted as of October 1, 2000, warrants to purchase common stock of publicly traded companies are generally considered derivatives and marked to market through current earnings as realized gains and losses. Realized losses on securities in 2001 includes gains of \$60,000 in the third quarter and \$2.4 million in the first nine months to adjust the carrying value of AFG's investment in warrants to market value.

**Gain (Loss) on Subsidiaries** Gain (loss) on sales of subsidiaries in 2001 includes a third quarter pretax gain of \$7.1 on the sale of Seven Hills Insurance Company and a first quarter pretax loss of \$1.6 million representing an adjustment to the fourth quarter 2000 loss recorded on the sale of the Japanese division. In 2000, AFG recognized a \$25 million gain in the second quarter representing an earn-out related to the 1998 sale of its Commercial lines division and a \$6 million loss in the third quarter on the sale of Stonewall Insurance Company.

**Gain on Other Investments** In September 2000, GAFRI realized a \$27.2 million pretax gain on the sale of its minority ownership in a company engaged in the production of ethanol.

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

**Annuity Benefits** Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. The majority of GAFRI's fixed rate annuity products permit GAFRI to change the crediting rate at any time (subject to minimum interest rate guarantees of 3% or 4% per annum). As a result, management has been able to react to changes in market interest rates and maintain a desired interest rate spread. In 2000, annuity benefits also includes a second quarter charge of \$14.2 million related to the settlement of a policyholder class action lawsuit.

GAFRI's equity-indexed fixed annuities provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. GAFRI attempts to mitigate the risk in the equity-based component of these products through the purchase of call options on the appropriate index. GAFRI's strategy is designed so that an increase in the liabilities due to an increase in the market index will be substantially offset by unrealized gains on the call options. Under SFAS No. 133, both the equity-based component of the annuities and the related call options are considered derivatives and marked to market through current earnings as annuity benefits. Adjusting these derivatives to market value had a net effect of less than \$1 million on annuity benefits during the third quarter or the first nine months of 2001.

**Interest Expense** Interest expense for the third quarter and nine months of 2001 decreased compared to 2000 as lower average interest rates on AFG's variable rate debt and lower average subsidiary indebtedness more than offset higher average borrowings under the AFC bank line.

**Other Operating and General Expenses** Other operating and general expenses for 2000 include second quarter charges of \$18.3 million related to the settlement of the policyholder class action lawsuit against a GAFRI subsidiary and \$8.8 million for an adverse California Supreme Court ruling against an AFG property and casualty subsidiary. Excluding these litigation charges, other operating and general expenses increased \$28 million (9%) for the first nine months of 2001 compared to 2000 due primarily to increased expenses associated with the IT initiative and slightly higher holding company expenses.

**Investee Corporations** Equity in losses of investee corporations in 2001 represents losses of two start-up manufacturing businesses (see Note D). Investee losses in 2001 include a third quarter judgement of \$2.7 million against one of the companies for the misappropriation of a trade secret and the infringement of a patent. In November 2001, an injunction was issued which would prohibit the company from using the equipment which was the subject of the trade secret claim and effectively close the plant. The injunction was subsequently modified, pending appeal, to permit operations to continue and require certain escrow payments. If the investee is unsuccessful in its attempt to have the injunction lifted or further modified, a substantial portion of AFG's investment (\$35 million as of November 1, 2001), may be written off.

Equity in net losses of investees in 2000 represents AFG's proportionate share of Chiquita's earnings. Due to Chiquita's restructuring plans, AFG suspended its use of equity accounting in 2001.

**Cumulative Effect of Accounting Change** The cumulative effect of accounting change represents the implementation of a new accounting standard (EITF 99-20) which resulted in a write down of \$16.9 million (\$10.0 million or \$.15 per share after tax and minority interest) of the carrying value of certain collateralized debt obligations as of April 1, 2001.

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

**Recent Accounting Standards** In July 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations", and No. 142, "Goodwill and Other Intangible Assets." Under SFAS No. 141, business combinations initiated after June 30, 2001 are required to be accounted for using the purchase method of accounting. Under SFAS No. 142, goodwill will no longer be required to be amortized beginning January 1, 2002, but will be subject to an impairment test at least annually. A transitional test for impairment is required to be completed in 2002 with any resulting writedown reported during the first quarter as a cumulative effect of a change in accounting principle. Based on current levels of goodwill, amortization is approximately \$3.5 million per quarter.

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**Item 3**

**Quantitative and Qualitative Disclosure of Market Risk**

As of September 30, 2001, there were no material changes to the information provided in AFG's Form 10-K for 2000 under the caption "Exposure to Market Risk" in Management's Discussion and Analysis of Financial Condition and Results of Operations.

AMERICAN FINANCIAL GROUP, INC. 10-Q  
PART II  
OTHER INFORMATION - CONTINUED

Item 5

Other Information

The following is an excerpt from AFG's third quarter earnings release dated November 2, 2001.

Common Stock Dividend Reduction

According to [AFG's Chairman and Chief Executive Officer], "The opportunity presented by significant price firming in the marketplace leads us to believe that the best interests of the company and its shareholders are served by retaining available capital to grow our profitable insurance operations and build long-term value."

In that light, the company . . . expects to reduce its annual dividend on its Common Stock from \$1.00 to \$.50 per share, representing a yield of about 2-1/4% on the current market price of the stock. This will retain more than \$30 million of capital in the business. [The Chairman and CEO] said, "We believe this method of providing capital to our growing businesses is prudent in the circumstances and that the dividend yield is more in line with our industry peers. In addition, it seems to be appropriate in relation to our expectation of 2002 operating earnings of between \$2.20 and \$2.40 per share."

Item 6

Exhibits and Reports on Form 8-K

(a) Exhibits: none

(b) Reports on Form 8-K:

<u>Date of Report</u>	<u>Item Reported</u>
August 2, 2001	Second quarter 2001 Earnings Release

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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 14, 2001

BY: Fred J. Runk  
Fred J. Runk  
Senior Vice President and Treasurer