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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  
March 31, 2002**

**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 May 1, 2002, there were 68,702,382 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)

|  | March 31,<br>2002 | December 31,<br>2001 |
|--|-------------------|----------------------|
| <b>Assets:</b>   |                   |                      |
| Cash and short-term investments  | \$ 274,346        | \$ 544,173           |
| Investments:   |                   |                      |
| Fixed maturities - at market<br>(amortized cost - \$11,050,349 and \$10,593,305) | 11,077,749        | 10,748,605           |
| Other stocks - at market<br>(cost - \$180,945 and \$187,810)                     | 321,245           | 313,710              |
| Policy loans   | 208,430           | 211,288              |
| Real estate and other investments  | 263,466           | 266,545              |
| Total investments  | 11,870,890        | 11,540,148           |
| Recoverables from reinsurers and prepaid<br>reinsurance premiums                 | 2,341,013         | 2,286,509            |
| Agents' balances and premiums receivable   | 704,928           | 666,171              |
| Deferred acquisition costs   | 852,030           | 818,323              |
| Other receivables  | 280,958           | 254,255              |
| Variable annuity assets (separate accounts)                                      | 560,821           | 529,590              |
| Prepaid expenses, deferred charges and other assets                              | 495,668           | 453,718              |
| Goodwill   | 309,254           | 308,794              |
|  | \$17,689,908      | \$17,401,681         |
| <b>Liabilities and Capital:</b>  |                   |                      |
| Unpaid losses and loss adjustment expenses                                       | \$ 4,835,895      | \$ 4,777,580         |
| Unearned premiums  | 1,720,065         | 1,640,955            |
| Annuity benefits accumulated   | 5,931,565         | 5,832,120            |
| Life, accident and health reserves   | 653,458           | 638,522              |
| Long-term debt:  |                   |                      |
| Holding companies  | 630,274           | 608,960              |
| Subsidiaries   | 270,412           | 270,752              |
| Variable annuity liabilities (separate accounts)                                 | 560,821           | 529,590              |
| Accounts payable, accrued expenses and other<br>liabilities                      | 1,165,945         | 1,150,093            |
| Total liabilities  | 15,768,435        | 15,448,572           |
| Minority interest  | 449,282           | 454,730              |
| <b>Shareholders' Equity:</b>   |                   |                      |
| Common Stock, no par value   |                   |                      |
| - 200,000,000 shares authorized  |                   |                      |
| - 68,655,751 and 68,491,610 shares outstanding                                   | 68,656            | 68,492               |
| Capital surplus  | 914,514           | 911,074              |
| Retained earnings  | 392,721           | 359,513              |
| Unrealized gain on marketable securities, net                                    | 96,300            | 159,300              |
| Total shareholders' equity   | 1,472,191         | 1,498,379            |
|  | \$17,689,908      | \$17,401,681         |

AMERICAN FINANCIAL GROUP, INC. 10-Q

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

|   | Three months ended<br>March 31, |                  |
|---|---------------------------------|------------------|
|   | <u>2002</u>                     | <u>2001</u>      |
| <b>Income:</b>                                |                                 |                  |
| Property and casualty insurance premiums      | \$603,908                       | \$644,723        |
| Life, accident and health premiums            | 70,935                          | 69,158           |
| Investment income                             | 219,771                         | 208,552          |
| Realized losses on:                           |                                 |                  |
| Securities                                    | (17,800)                        | (6,881)          |
| Subsidiaries                                  | -                               | (1,586)          |
| Other income                                  | 48,322                          | 58,284           |
|   | <u>925,136</u>                  | <u>972,250</u>   |
| <b>Costs and Expenses:</b>                    |                                 |                  |
| Property and casualty insurance:              |                                 |                  |
| Losses and loss adjustment expenses           | 442,913                         | 496,216          |
| Commissions and other underwriting expenses   | 170,266                         | 184,974          |
| Annuity benefits                              | 75,525                          | 69,264           |
| Life, accident and health benefits            | 55,920                          | 54,083           |
| Interest charges on borrowed money            | 14,193                          | 16,800           |
| Other operating and general expenses          | 115,465                         | 110,065          |
|   | <u>874,282</u>                  | <u>931,402</u>   |
| Operating earnings before income taxes        | 50,854                          | 40,848           |
| Provision for income taxes                    | 673                             | 14,432           |
| Net operating earnings                        | 50,181                          | 26,416           |
| Minority interest expense, net of tax         | (5,677)                         | (9,952)          |
| Equity in net losses of investees, net of tax | (2,734)                         | (3,334)          |
| <b>Net Earnings</b>                           | <u>\$ 41,770</u>                | <u>\$ 13,130</u> |
| <b>Earnings per Common Share:</b>             |                                 |                  |
| Basic   | \$.61                           | \$.19            |
| Diluted                                       | \$.61                           | \$.19            |
| <b>Average number of Common Shares:</b>       |                                 |                  |
| Basic   | 68,556                          | 67,510           |
| Diluted                                       | 69,019                          | 67,933           |
| Cash dividends per Common Share               | \$.125                          | \$.25            |

AMERICAN FINANCIAL GROUP, INC. 10-Q

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

|   | Common<br>Shares  | Common Stock<br>and Capital<br>Surplus | Retained<br>Earnings | Unrealized<br>Gain on<br>Securities | Total              |
|---|-------------------|--|----------------------|-------------------------------------|--------------------|
| <b>Balance at January 1, 2002</b>                   | 68,491,610        | \$979,566                              | \$359,513            | \$159,300                           | \$1,498,379        |
| Net earnings  | -                 | -                                      | 41,770               | -                                   | 41,770             |
| Change in unrealized<br>Comprehensive income (loss) | -                 | -                                      | -                    | (63,000)                            | (63,000)           |
|   |                   |  |                      |                                     | (21,230)           |
| Dividends on Common Stock                           | -                 | -                                      | (8,562)              | -                                   | (8,562)            |
| Shares issued:                                      |                   |  |                      |                                     |                    |
| Exercise of stock options                           | 13,155            | 310                                    | -                    | -                                   | 310                |
| Dividend reinvestment plan                          | 49,333            | 1,121                                  | -                    | -                                   | 1,121              |
| Employee stock purchase plan                        | 11,465            | 283                                    | -                    | -                                   | 283                |
| Retirement plan contributions                       | 87,690            | 2,405                                  | -                    | -                                   | 2,405              |
| Directors fees paid in stock                        | 1,002             | 24                                     | -                    | -                                   | 24                 |
| Tax effect of intercompany dividends                | -                 | (800)                                  | -                    | -                                   | (800)              |
| Other   | 1,496             | 261                                    | -                    | -                                   | 261                |
| <b>Balance at March 31, 2002</b>                    | <u>68,655,751</u> | <u>\$983,170</u>                       | <u>\$392,721</u>     | <u>\$ 96,300</u>                    | <u>\$1,472,191</u> |
| <br>  |                   |  |                      |                                     |                    |
| <b>Balance at January 1, 2001</b>                   | 67,410,091        | \$965,476                              | \$442,454            | \$140,600                           | \$1,548,530        |
| Net earnings  | -                 | -                                      | 13,130               | -                                   | 13,130             |
| Change in unrealized<br>Comprehensive income        | -                 | -                                      | -                    | 36,300                              | 36,300             |
|   |                   |  |                      |                                     | 49,430             |
| Dividends on Common Stock                           | -                 | -                                      | (16,854)             | -                                   | (16,854)           |
| Shares issued:                                      |                   |  |                      |                                     |                    |
| Exercise of stock options                           | 22,842            | 491                                    | -                    | -                                   | 491                |
| Employee stock purchase plan                        | 15,022            | 385                                    | -                    | -                                   | 385                |
| Retirement plan contributions                       | 385,277           | 9,149                                  | -                    | -                                   | 9,149              |
| Directors fees paid in stock                        | 996               | 24                                     | -                    | -                                   | 24                 |
| Tax effect of intercompany dividends                | -                 | (1,600)                                | -                    | -                                   | (1,600)            |
| Other   | 328               | (250)                                  | -                    | -                                   | (250)              |
| <b>Balance at March 31, 2001</b>                    | <u>67,834,556</u> | <u>\$973,675</u>                       | <u>\$438,730</u>     | <u>\$176,900</u>                    | <u>\$1,589,305</u> |

AMERICAN FINANCIAL GROUP, INC. 10-Q

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

|   | Three months ended<br>March 31, |                  |
|---|---------------------------------|------------------|
|   | <u>2002</u>                     | <u>2001</u>      |
| <b>Operating Activities:</b>                                |                                 |                  |
| Net earnings  | \$ 41,770                       | \$ 13,130        |
| Adjustments:  |                                 |                  |
| Equity in net losses of investees                           | 2,734                           | 3,334            |
| Depreciation and amortization                               | 44,412                          | 36,574           |
| Annuity benefits  | 75,525                          | 69,264           |
| Realized (gains) losses on investing activities             | 17,605                          | (6,840)          |
| Deferred annuity and life policy acquisition costs          | (38,600)                        | (35,551)         |
| Decrease (increase) in reinsurance and other<br>receivables | (119,964)                       | 5,434            |
| Increase in other assets                                    | (10,166)                        | (19,934)         |
| Increase in insurance claims and reserves                   | 152,361                         | 74,616           |
| Increase in other liabilities                               | 7,904                           | 35,660           |
| Increase in minority interest                               | 952                             | 4,260            |
| Other, net  | 755                             | 3,491            |
|   | <u>175,288</u>                  | <u>183,438</u>   |
| <b>Investing Activities:</b>                                |                                 |                  |
| Purchases of and additional investments in:                 |                                 |                  |
| Fixed maturity investments                                  | (1,499,179)                     | (544,186)        |
| Equity securities   | -                               | (2,571)          |
| Real estate, property and equipment                         | (4,518)                         | (13,278)         |
| Maturities and redemptions of fixed maturity<br>investments | 408,962                         | 131,547          |
| Sales of:   |                                 |                  |
| Fixed maturity investments                                  | 597,159                         | 194,182          |
| Equity securities   | 5,164                           | 4,679            |
| Subsidiaries  | -                               | 22,000           |
| Real estate, property and equipment                         | 1,669                           | 24,562           |
| Cash and short-term investments of former<br>subsidiaries   | -                               | (132,858)        |
| Decrease (increase) in other investments                    | 3,368                           | (673)            |
|   | <u>(487,375)</u>                | <u>(316,596)</u> |
| <b>Financing Activities:</b>                                |                                 |                  |
| Fixed annuity receipts                                      | 169,872                         | 126,223          |
| Annuity surrenders, benefits and withdrawals                | (135,912)                       | (186,921)        |
| Net transfers from (to) variable annuity assets             | (5,570)                         | 2,929            |
| Additional long-term borrowings                             | 41,000                          | 26,842           |
| Reductions of long-term debt                                | (20,240)                        | (47,601)         |
| Issuances of Common Stock                                   | 551                             | 818              |
| Cash dividends paid   | (7,441)                         | (16,854)         |
|   | <u>42,260</u>                   | <u>(94,564)</u>  |
| <b>Net Decrease in Cash and Short-term Investments</b>      | (269,827)                       | (227,722)        |
| Cash and short-term investments at beginning<br>of period   | <u>544,173</u>                  | <u>438,670</u>   |
| Cash and short-term investments at end of period            | <u>\$ 274,346</u>               | <u>\$210,948</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 cost basis of that investment is reduced.

Emerging Issues Task Force Issue No. 99-20 established a new standard for recognizing interest income and impairment on certain asset-backed investments. Interest income on these investments is recorded at a yield based on projected cash flows. The yield is adjusted prospectively to reflect actual cash flows and changes in projected amounts. Impairment losses on these investments must be recognized when (i) the fair value of the security is less than its cost basis 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.

**Goodwill** Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Through December 31, 2001, goodwill was being amortized over periods of 20 to 40 years. Effective January 1, 2002, AFG implemented Statement of Financial Accounting Standards ("SFAS") No. 142, under which goodwill is no longer amortized but is subject to an impairment test at least annually. As required under SFAS No. 142, AFG will complete the transitional test for goodwill impairment (as of January 1, 2002) by the end of 2002. Any resulting write-down will be reported by restating first quarter 2002 results for the cumulative effect of a change in accounting principle.

## 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.

**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 ("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.

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. 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 (losses) on marketable securities.

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 Earnings 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**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.

**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, who retains all investment risk. Accordingly, GAFRI's liability for these accounts equals the value of the account assets.

**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 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



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Under AFG's stock option plan, options are granted to officers, directors and key employees at exercise prices equal to the fair value of the shares at the dates of grant. No compensation expense is recognized for stock option grants.

**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. The Company makes all contributions to the retirement fund and matches a portion of employee contributions to the savings fund. Employees have been permitted to direct the investment of their contributions to independently managed investment funds, while Company contributions have been invested primarily in securities of AFG and affiliates. Employees are being afforded the flexibility to direct the investment of a portion of their vested retirement fund account balances (increasing from 12.5% in July 2002 to 100% in April 2004) from securities of AFG and its affiliates to independently managed investment funds. The Plan owns 12% of AFG's outstanding Common Stock. Company contributions 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** 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. Changes in the fair value of derivatives are included in current earnings.

**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 463,000 shares in 2002 and 423,000 shares in 2001 representing the dilutive effect of common stock options.

**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 Subsidiaries**

**Manhattan National Life Insurance** In March 2002, GAFRI reached an agreement to acquire Manhattan National Life Insurance Company ("MNL") from Conseco, Inc. for \$48.5 million in cash. GAFRI expects to close on this transaction in the second quarter of 2002 and to fund this acquisition with cash on hand and through reinsurance of up to 90% of the business in force. While MNL is not currently writing new policies, the company reported over \$43 million of statutory renewal premiums in 2001. At December 31, 2001, MNL had approximately 90,000 policies

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

in force (primarily term life) representing over \$12 billion in face amount of insurance, statutory assets of \$297.8 million and statutory capital and surplus of \$23.1 million.

**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 an estimated \$10.7 million pretax loss. 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; the deferred gain is being recognized over the estimated settlement period (weighted average of 4 years) of the ceded claims.

- C. **Segments of Operations** AFG's property and casualty group is engaged primarily in specialty and private passenger automobile 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.

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<br>March 31, |                  |
|----------------------------------|---------------------------------|------------------|
|                                  | <u>2002</u>                     | <u>2001</u>      |
| <b>Revenues (a)</b>              |                                 |                  |
| Property and casualty insurance: |                                 |                  |
| Premiums earned:                 |                                 |                  |
| Specialty                        | \$356,415                       | \$316,307        |
| Personal                         | 247,203                         | 327,632          |
| Other lines (b)                  | 290                             | 784              |
|                                  | <u>603,908</u>                  | <u>644,723</u>   |
| Investment and other income      | 100,259                         | 107,335          |
|                                  | <u>704,167</u>                  | <u>752,058</u>   |
| Annuities, life and health (c)   | 217,422                         | 217,030          |
| Other                            | 3,547                           | 3,162            |
|                                  | <u>\$925,136</u>                | <u>\$972,250</u> |
| <b>Operating Profit (Loss)</b>   |                                 |                  |
| Property and casualty insurance: |                                 |                  |
| Underwriting:                    |                                 |                  |
| Specialty                        | \$ 5,294                        | (\$ 2,230)       |
| Personal                         | (5,239)                         | (27,782)         |
| Other lines (b)                  | (9,326)                         | (6,455)          |
|                                  | <u>(9,271)</u>                  | <u>(36,467)</u>  |
| Investment and other income      | 63,251                          | 75,202           |
|                                  | <u>53,980</u>                   | <u>38,735</u>    |
| Annuities, life and health       | 21,981                          | 30,123           |
| Other (d)                        | (25,107)                        | (28,010)         |
|                                  | <u>\$ 50,854</u>                | <u>\$ 40,848</u> |

- (a) Revenues include sales of products and services as well as other income earned by the respective segments.  
 (b) Represents lines in "run-off"; AFG has ceased underwriting new business in these operations.  
 (c) Represents primarily investment income.  
 (d) Includes holding company expenses.

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

D. **Goodwill** Effective January 1, 2002, goodwill is no longer amortized. If the \$3.4 million (\$.05 per share) of goodwill amortization had not been deducted in the first quarter of 2001, net earnings for that period would have been \$16.6 million (\$.24 per share).

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

|  | March 31,<br>2002 | December 31,<br>2001 |
|--|-------------------|----------------------|
| <b>Holding Companies:</b>                      |                   |                      |
| AFG 7-1/8% Senior Debentures due April 2009    | \$301,156         | \$301,108            |
| AFG 7-1/8% Senior Debentures due December 2007 | 79,600            | 79,600               |
| AFC notes payable under bank line              | 225,000           | 203,000              |
| APU 10-7/8% Subordinated Notes due May 2011    | 11,542            | 11,557               |
| Other  | <u>12,976</u>     | <u>13,695</u>        |
|  | <u>\$630,274</u>  | <u>\$608,960</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           | 121,100              |
| Notes payable secured by real estate           | 36,081            | 36,253               |
| Other  | <u>13,231</u>     | <u>13,399</u>        |
|  | <u>\$270,412</u>  | <u>\$270,752</u>     |

At March 31, 2002, sinking fund and other scheduled principal payments on debt for the balance of 2002 and the subsequent five years were as follows (in millions):

|      | Holding<br>Companies | Subsidiaries | Total   |
|------|----------------------|--------------|---------|
| 2002 | \$234.9              | \$ .9        | \$235.8 |
| 2003 | -                    | 1.2          | 1.2     |
| 2004 | -                    | 122.4        | 122.4   |
| 2005 | -                    | 10.4         | 10.4    |
| 2006 | -                    | 19.1         | 19.1    |
| 2007 | 79.7                 | .6           | 80.3    |

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.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

|   | March 31,<br>2002 | December 31,<br>2001 |
|---|-------------------|----------------------|
| Interest of noncontrolling shareholders in subsidiaries' common stock | \$135,465         | \$140,913            |
| Preferred securities issued by subsidiary trusts                      | 241,663           | 241,663              |
| AFC preferred stock   | <u>72,154</u>     | <u>72,154</u>        |
|   | <u>\$449,282</u>  | <u>\$454,730</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)     | March 31,<br>2002 | December 31,<br>2001 | Optional Redemption Dates |
|------------------|---------------------------|-------------------|----------------------|---------------------------|
| October 1996     | AFCH 9-1/8% TOPrS (2026)  | \$98,750          | \$98,750             | Currently redeemable      |
| November 1996    | GAFRI 9-1/4% TOPrS (2026) | 72,913            | 72,913               | Currently redeemable      |
| March 1997       | GAFRI 8-7/8% Pfd (2027)   | 70,000            | 70,000               | On or after 3/1/2007      |

**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):

|   | Three months ended<br>March 31, |                |
|---|---------------------------------|----------------|
|   | 2002                            | 2001           |
| Interest of noncontrolling shareholders in earnings of subsidiaries   | \$3,181                         | \$4,131        |
| Effect of basis difference in realized gains (losses) of subsidiaries | (2,517)                         | -              |
| Accrued distributions by subsidiaries on preferred securities:        |                                 |                |
| Trust issued securities, net of tax                                   | 3,570                           | 4,378          |
| AFC preferred stock   | <u>1,443</u>                    | <u>1,443</u>   |
|   | <u>\$5,677</u>                  | <u>\$9,952</u> |

- G. **Shareholders' Equity** At March 31, 2002, there were 68,655,751 shares of AFG Common Stock outstanding, including 1,362,680 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

At March 31, 2002, there were 9.7 million shares of AFG Common Stock reserved for issuance upon exercise of stock options. As of that date, options for 7 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. Options generally expire ten years after the date of grant.

The change in unrealized gain on marketable securities for the three months ended March 31 included the following (in millions):

|   | <u>Pretax</u>    | <u>Taxes</u>    | <u>Minority<br/>Interest</u> | <u>Net</u>      |
|---|------------------|-----------------|------------------------------|-----------------|
| <u>2002</u>   |                  |                 |                              |                 |
| Unrealized holding losses on securities arising during the period | (\$124.3)        | \$43.3          | \$9.6                        | (\$71.4)        |
| Realized losses included in net income                            | <u>17.8</u>      | <u>(6.2)</u>    | <u>(3.2)</u>                 | <u>8.4</u>      |
| Change in unrealized gain on marketable securities, net           | <u>(\$106.5)</u> | <u>\$37.1</u>   | <u>\$6.4</u>                 | <u>(\$63.0)</u> |
| <u>2001</u>   |                  |                 |                              |                 |
| Unrealized holding gains on securities arising during the period  | \$ 59.0          | (\$20.6)        | (\$6.4)                      | \$32.0          |
| Realized losses included in net income                            | <u>6.9</u>       | <u>(2.4)</u>    | <u>(.2)</u>                  | <u>4.3</u>      |
| Change in unrealized gain on marketable securities, net           | <u>\$ 65.9</u>   | <u>(\$23.0)</u> | <u>(\$6.6)</u>               | <u>\$36.3</u>   |

- H. **Equity in Losses of Investees** 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.

During 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 loans (\$61.5 million at December 31, 2000) owed to AFG subsidiaries, the sale was not recognized as a divestiture for accounting purposes. Assets of the businesses transferred (\$56.1 million at March 31, 2002 and \$57.1 million at December 31, 2001) are included in other assets; liabilities of the businesses transferred (\$11.7 million at March 31, 2002 and \$11.8 million at December 31, 2001, after consolidation and elimination of loans from AFG subsidiaries) are included in other liabilities. Investee losses in the Statement of Earnings represents AFG's equity in the losses of these two companies. One of the businesses is involved in litigation impacting its operations; see "Investee Corporations" in Management's Discussion and Analysis.

- I. **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 2001.

ITEM 2

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

**GENERAL**

AFG and its subsidiaries, 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 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. Examples of such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings and investment activities; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate increases, improved loss experience and expected expense savings resulting from recent initiatives.

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;
- tax law changes;
- levels of catastrophes and other major losses;
- the ultimate amount of liabilities associated with certain asbestos and environmental-related insurance claims;
- adequacy of loss reserves;
- availability of reinsurance and ability of reinsurers to pay their obligations; and
- competitive pressures, including the ability to obtain rate increases.

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

AMERICAN FINANCIAL GROUP, INC. 10-Q

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

**LIQUIDITY AND CAPITAL RESOURCES**

**Ratios** AFG's debt to total capital ratio (at the parent holding company level) was approximately 28% at March 31, 2002, and 27% at December 31, 2001. AFG's ratio of earnings to fixed charges (on a total enterprise basis) was 2.72 for the first three months of 2002 and 1.21 for the entire year 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.

AFG has a revolving credit agreement with several banks under which it can borrow up to \$300 million until December 31, 2002. At March 31, 2002, three-fourths of the credit line had been used. While management expects to negotiate a replacement bank agreement later this year, market conditions indicate the maximum amount may be smaller and interest costs will likely be greater.

**Investments** AFG's investment portfolio at March 31, 2002, contained \$11.1 billion in "Fixed maturities" and \$321 million in "Other stocks", all carried at market value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At March 31, 2002, AFG had pretax net unrealized gains of \$27.4 million on fixed maturities and \$140.3 million on other stocks.

Approximately 93% of the fixed maturities held by AFG at March 31, 2002, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and noninvestment grade. Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

Individual portfolio securities are sold creating gains or losses as market opportunities exist. Since all of these securities are carried at market value in the balance sheet, there is virtually no effect on liquidity or financial condition upon the sale and ultimate realization of unrealized gains and losses.

AMERICAN FINANCIAL GROUP, INC. 10-Q

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

Summarized information for the unrealized gains and losses recorded in AFG's balance sheet at March 31, 2002, follows (dollars in millions):

|  | <u>Securities with</u> |               |
|--|------------------------|---------------|
|  | <u>Gains</u>           | <u>Losses</u> |
| <u>Fixed Maturities</u>  |                        |               |
| Market value   | \$6,100                | \$4,600       |
| Gross unrealized   | \$ 228                 | \$ 201        |
| Number of security positions   | 1,200                  | 600           |
| Number individually exceeding<br>\$2 million gain or loss                                | 4                      | 11            |
| Concentration of gains or losses by<br>type or industry (exceeding 5% of<br>unrealized): |                        |               |
| Mortgage-backed securities   | \$ 75.2                | \$ 36.5       |
| U.S. Treasuries  | 14.2                   | 11.0          |
| Telephone communications   | 3.2                    | 33.3          |
| Banks  | 24.0                   | 1.9           |
| Electric services  | 7.7                    | 12.3          |
| Air transportation   | 1.5                    | 11.3          |
| Percentage rated investment grade  | 96%                    | 90%           |
| <u>Other Stocks</u>  |                        |               |
| Market value   | \$ 265                 | \$ 19         |
| Gross unrealized   | \$ 152                 | \$ 12         |
| Number individually exceeding<br>\$2 million gain or loss                                | 3                      | 2             |

AFG's investment in equity securities of Provident Financial Group, a Cincinnati-based commercial banking and financial services company, represents \$137 million of the \$152 million in unrealized gains on other stocks at March 31, 2002.

The table below sets forth the scheduled maturities of fixed maturity securities (by separate gain/loss segments and in total) at March 31, 2002, based on their market values.

| Maturity                           | <u>Unrealized</u> |               | Total       |
|------------------------------------|-------------------|---------------|-------------|
|                                    | <u>Gains</u>      | <u>Losses</u> |             |
| One year or less                   | 9%                | 1%            | 6%          |
| After one year through five years  | 27                | 15            | 22          |
| After five years through ten years | 18                | 40            | 27          |
| After ten years                    | 16                | 14            | 15          |
|                                    | <u>70</u>         | <u>70</u>     | <u>70</u>   |
| Mortgage-backed securities         | 30                | 30            | 30          |
|                                    | <u>100%</u>       | <u>100%</u>   | <u>100%</u> |

AFG realized aggregate losses of \$5.9 million during the first three months of 2002 on \$71.1 million in sales of fixed maturity securities (16 issues) that had unrealized losses at December 31, 2001. Market values of ten of the issues improved from year-end to date of sale while the other six deteriorated; overall, there was a slight net improvement. Of the three with unrealized losses greater than \$500,000 at year-end, actual losses on sale were \$1.1 million less than the unrealized loss at year-end. Although AFG had the ability to continue holding these investments, its intent to hold them changed due to a variety of reasons including actual or expected deterioration in the issuer's credit and decisions to lessen exposure to a particular credit or industry.



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

The length of time securities with unrealized losses at March 31, 2002, have been in an unrealized loss position varies by individual security. Of the 96 individual securities at that date with unrealized losses exceeding \$500,000, 78 have been in that position for less than one year, including 68 that have been in that position for less than six months. Of the 111 individual securities at that date with unrealized gains exceeding \$500,000, 48 have been in that position for less than one year, including 9 that have been in that position for less than six months.

When a decline in the value of a specific investment is considered to be "other than temporary," a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are "other than temporary" requires judgment based on subjective as well as objective factors. A listing of factors considered and resources used is contained in the discussion of "Investments" under Management's Discussion and Analysis in AFG's 2001 Form 10-K.

Based on its analysis, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they mature or recover in value. Should either of these beliefs change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary impairment could be material to results of operations in a future period. Management believes it is not likely that future impairment charges will have a significant effect on AFG's liquidity.

**Uncertainties** Aside from risks common to most insurance operations, management believes that the areas posing the greatest risk of material loss are Great American's exposure to asbestos, environmental and other mass tort claims and American Premier's exposure to asbestos, environmental and other contingencies arising out of its former operations.

**Property and Casualty Insurance Reserves** Future costs of claims are projected based on historical trends adjusted for changes in underwriting standards, policy provisions, product mix and other factors. Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors which are subject to significant variation. Through the use of analytical reserve development techniques, management monitors items such as the effect of inflation on medical, hospitalization, material, repair and replacement costs, general economic trends and the legal environment.

**Asbestos and Environmental-related ("A&E") Reserves** Establishing reserves for A&E claims is subject to uncertainties that are significantly greater than those presented by other types of claims. Estimating ultimate liability for asbestos claims presents unique and difficult challenges to the insurance industry 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. The casualty insurance industry is engaged, as is AFG, in extensive litigation over these coverage and liability issues as the volume and severity of claims against asbestos defendants continue to increase.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

While management believes that AFG's reserves for A&E claims are a reasonable estimate of ultimate liability for such claims, actual results may vary materially from the amount currently recorded due to outstanding issues and uncertainties such as whether coverage exists, whether claims are to be allocated among triggered policies and implicated years, whether claimants who exhibit no signs of illness will be successful in pursuing their claims, predicting the number of future claims, and the impact of recent bankruptcy filings.

Further, certain policyholders assert that each bodily injury claim should be treated as a separate occurrence under the policy, and that their claims are not subject to aggregate limits on coverage because either their policies did not 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, the outcome of this litigation is uncertain and such claims may have a material adverse effect upon AFG's future results of operations and financial condition.

For further discussion of uncertainties and litigation involving AFG, see Note L "Commitments and Contingencies" to the financial statements and "Legal Proceedings" in AFG's Annual Report on Form 10-K for 2001.

#### RESULTS OF OPERATIONS

**General** Results of operations as shown in the accompanying financial statements are prepared in accordance with generally accepted accounting principles. Many investors and analysts focus on "core earnings" of companies, setting aside certain items included in net earnings.

The following table reconciles AFG's operating earnings before income taxes as shown in the Statement of Earnings to "core earnings" as generally referred to in quarterly news releases and independent financial analysts' reports (in millions, except per share amounts):

|   | Three months ended |               |
|---|--------------------|---------------|
|   | March 31,          |               |
|   | <u>2002</u>        | <u>2001</u>   |
| Operating earnings before income taxes  | \$50.9             | \$40.8        |
| Adjustments:                            |                    |               |
| Eliminate net realized losses           | 17.8               | 8.5           |
| Include minority interest               | <u>(10.9)</u>      | <u>(12.5)</u> |
|   | 57.8               | 36.8          |
| Provision for income taxes              | <u>(4.9)</u>       | <u>(15.0)</u> |
| Core earnings from insurance businesses | <u>\$52.9</u>      | <u>\$21.8</u> |
| Per Common Share (diluted)              | <u>\$.77</u>       | <u>\$.32</u>  |

"Core earnings" for 2002 include a \$16 million (\$.24 per share) tax benefit resulting from the reversal of previously accrued amounts due to the resolution of certain tax matters. "Core earnings" for 2001 include goodwill amortization expense of \$3.4 million (\$.05 per share). The improvement in comparable first quarter results was due primarily to significantly improved property and

AMERICAN FINANCIAL GROUP, INC. 10-Q

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

casualty underwriting results, partially offset by a decrease in income from the sale of real estate.

**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.

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

|  | Three months ended |                |
|--|--------------------|----------------|
|  | March 31,          |                |
|  | 2002               | 2001           |
| <u>Net Written Premiums (GAAP)</u>       |                    |                |
| Specialty                                | \$386.7            | \$356.6 (a)    |
| Personal                                 | 256.4 (b)          | 370.5          |
| Other lines                              | .3                 | -              |
|  | <u>\$643.4</u>     | <u>\$727.1</u> |
| <u>Combined Ratios (GAAP)</u>            |                    |                |
| Specialty                                | 98.5%              | 100.6%         |
| Personal                                 | 102.1              | 108.5          |
| Aggregate (including discontinued lines) | 101.4              | 105.6          |

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

(b) Reflects the ceding of \$88.7 million in premiums under a reinsurance agreement (effective April 1, 2001).

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

**Specialty** The Specialty group's increase in net written premiums reflects the impact of rate increases and the realization of growth opportunities in certain commercial markets, partially offset by the decision to discontinue certain lines of business (during 2001) that were not achieving adequate returns and by additional reinsurance agreements. Specialty rate increases averaged over 25% during the first quarter of 2002 and are expected to average approximately 20% for the year. The Specialty group reported a solid underwriting profit for the 2002 quarter with a combined ratio of 98.5%. The 2.1 point improvement in the combined ratio compared to 2001 reflects strategic changes in the mix of specialty businesses and the impact of rate increases.

**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 about 7%, reflecting lower business volume partially offset by the impact of rate increases. Rate increases implemented in the first quarter of 2002 were about 4% and are expected to range between 8% and 10% for the year. As a result of rate increases implemented over the last year, the combined ratio improved by 6.4 points over the first quarter of 2001. Management expects the Personal group to achieve underwriting profitability by the fourth quarter of 2002.

**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 |        |
|--------------------------------------|--------------------|--------|
|                                      | March 31,          |        |
|                                      | 2002               | 2001   |
| Other income                         | \$15.3             | \$32.0 |
| Other operating and general expenses | 14.5               | 15.0   |
| Interest charges on borrowed money   | .6                 | .7     |
| Minority interest expense, net       | -                  | 1.9    |

Other income includes net pretax gains on the sale of real estate assets of \$171,000 in the first quarter of 2002 and \$15.3 million in the first quarter of 2001.

**Other Income** Excluding gains on sales of real estate assets (discussed above), other income increased \$5.2 million (12%) due primarily to fees earned by certain new specialty insurance operations.

**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.

**Losses on Securities** Realized losses on securities include provisions for other than temporary impairment of securities still held of \$18.3 million in the first quarter of 2002 and \$8 million in the first quarter of 2001. Increased impairment charges in recent years reflect a rise in corporate defaults in the marketplace resulting from the weakened economy.

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

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 include losses of \$3 million in the first quarter of 2002 and \$.8 million in the first quarter of 2001 to adjust the carrying value of AFG's investment in warrants to market value (\$26.4 million at March 31, 2002).

**Loss on Subsidiaries** AFG recognized a \$1.6 million pretax loss in connection with the sale of the Japanese division in 2001.

**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.

**Interest Expense** Interest expense for the first quarter of 2002 decreased compared to 2001 as lower average interest rates on AFG's variable rate debt more than offset higher average indebtedness.

**Other Operating and General Expenses** Other operating and general expenses for the first quarter of 2001 include goodwill amortization of \$3.4 million. Under SFAS No. 142, which was implemented January 1, 2002, goodwill is no longer amortized. Excluding 2001 goodwill amortization, other operating and general expenses increased \$8.8 million (8%) due primarily to expenses related to certain new specialty insurance operations and increased amortization of annuity and life deferred acquisition costs.

**Income Taxes** The 2002 provision for income taxes includes a \$16 million tax benefit for the reversal of previously accrued amounts due to the resolution of certain tax matters.

**Investee Corporations** Equity in losses of investee corporations represents losses of two start-up manufacturing businesses (see Note H). In November 2001, an injunction was issued against one of the companies which would prohibit the company from using equipment subject to litigation alleging the misappropriation of a trade secret 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, or if operating results fail to improve, a substantial portion of AFG's investment (\$32.4 million as of March 31, 2002), may be written off.

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**Item 3**

**Quantitative and Qualitative Disclosure of Market Risk**

As of March 31, 2002, there were no material changes to the information provided in AFG's Form 10-K for 2001 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

Item 6

Exhibits and Reports on Form 8-K

- (a) Exhibit 10 - 2002 Annual Bonus Plan.
- (b) Reports on Form 8-K: none

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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.

May 13, 2002

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