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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, 2005**

**Commission File  
No. 1-13653**

**AMERICAN FINANCIAL GROUP, INC.**

**Incorporated under  
the Laws of Ohio**

**IRS Employer I.D.  
No. 31-1544320**

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant is an accelerated filer. Yes  No

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

As of November 1, 2005, there were 77,554,158 shares of the Registrant's Common Stock outstanding, excluding 9,953,392 shares owned by a subsidiary.

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AMERICAN FINANCIAL GROUP, INC.

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**AMERICAN FINANCIAL GROUP, INC. 10-Q**  
**PART I**  
**FINANCIAL INFORMATION**

**AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEET**  
(Dollars In Thousands)

	<u>September 30,</u> 2005	<u>December 31,</u> 2004
<b>Assets:</b>		
Cash and short-term investments	\$ 641,308	\$ 861,742
Investments:		
Fixed maturities:		
Available for sale - at market (amortized cost - \$14,087,625 and \$13,035,165)	14,229,925	13,411,365
Trading - at market	276,368	292,233
Other stocks - at market (cost - \$470,798 and \$456,053)	520,498	537,153
Policy loans	255,624	250,211
Real estate and other investments	330,567	283,929
Total cash and investments	<u>16,254,290</u>	<u>15,636,633</u>
Recoverables from reinsurers and prepaid reinsurance premiums	3,463,535	3,440,592
Agents' balances and premiums receivable	816,904	518,464
Deferred policy acquisition costs	1,190,751	1,114,433
Other receivables	250,215	359,746
Investments of managed investment entity	-	392,624
Variable annuity assets (separate accounts)	629,627	620,007
Prepaid expenses, deferred charges and other assets	375,266	311,146
Goodwill	165,882	165,882
	<u>\$23,146,470</u>	<u>\$22,559,527</u>
<b>Liabilities and Capital:</b>		
Unpaid losses and loss adjustment expenses	\$5,880,453	\$ 5,337,270
Unearned premiums	1,761,006	1,612,035
Annuity benefits accumulated	8,340,272	8,132,106
Life, accident and health reserves	1,070,593	1,021,986
Payable to reinsurers	462,236	513,565
Long-term debt:		
Holding company	667,630	685,083
Subsidiaries	349,120	343,590
Payable to subsidiary trusts	77,800	77,800
Debt of managed investment entity	-	371,368
Variable annuity liabilities (separate accounts)	629,627	620,007
Accounts payable, accrued expenses and other liabilities	1,243,920	1,194,584
Total liabilities	<u>20,482,657</u>	<u>19,909,394</u>
Minority interest	260,831	219,586
<b>Shareholders' Equity:</b>		
Common Stock, no par value		
- 200,000,000 shares authorized		
- 77,473,842 and 76,634,204 shares outstanding	77,474	76,634
Capital surplus	1,172,272	1,145,873
Retained earnings	1,059,536	976,340
Unrealized gain on marketable securities, net	93,700	231,700
Total shareholders' equity	<u>2,402,982</u>	<u>2,430,547</u>
	<u>\$23,146,470</u>	<u>\$22,559,527</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>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
<b>Income:</b>				
Property and casualty insurance premiums	\$ 651,361	\$ 549,296	\$1,775,795	\$1,565,617
Life, accident and health premiums	91,811	85,929	276,256	263,807
Investment income	214,076	201,631	640,734	589,613
Realized gains on securities	10,748	223,563	27,303	260,466
Revenues of managed investment entity	-	3,302	651	12,739
Other income	124,780	89,800	298,669	236,985
	<u>1,092,776</u>	<u>1,153,521</u>	<u>3,019,408</u>	<u>2,929,227</u>
<b>Costs and Expenses:</b>				
Property and casualty insurance:				
Losses and loss adjustment expenses	604,433	397,746	1,311,613	1,045,520
Commissions and other underwriting expenses	181,283	151,055	497,589	459,833
Annuity benefits	81,648	82,482	246,529	228,513
Life, accident and health benefits	72,436	63,981	211,014	199,200
Annuity, supplemental insurance and life acquisition expenses	34,296	29,439	103,366	92,292
Interest charges on borrowed money	18,367	18,050	54,789	53,235
Interest on subsidiary trust obligations	1,637	1,552	4,848	7,558
Expenses of managed investment entity	-	4,123	774	10,651
Other operating and general expenses	122,978	172,509	359,260	388,903
	<u>1,117,078</u>	<u>920,937</u>	<u>2,789,782</u>	<u>2,485,705</u>
Operating earnings (loss) before income taxes	(24,302)	232,584	229,626	443,522
Provision (credit) for income taxes	<u>(5,199)</u>	<u>78,031</u>	<u>84,577</u>	<u>144,673</u>
Net operating earnings (loss)	(19,103)	154,553	145,049	298,849
Minority interest expense	(7,261)	(10,987)	(22,075)	(22,651)
Equity in net losses of investee, net of tax	<u>(66)</u>	<u>(668)</u>	<u>(4,904)</u>	<u>(2,468)</u>
Earnings (loss) from continuing operations	(26,430)	142,898	118,070	273,730
Discontinued operations	-	(942)	-	(797)
Cumulative effect of accounting change	<u>-</u>	<u>(3,756)</u>	<u>-</u>	<u>(5,593)</u>
<b>Net Earnings (Loss)</b>	<u>(\$ 26,430)</u>	<u>\$ 138,200</u>	<u>\$ 118,070</u>	<u>\$ 267,340</u>
<b>Basic earnings (loss) per Common Share:</b>				
Continuing operations	(\$0.34)	\$1.94	\$1.53	\$3.73
Discontinued operations	-	(.01)	-	(.01)
Cumulative effect of accounting change	<u>-</u>	<u>(.05)</u>	<u>-</u>	<u>(.08)</u>
Net earnings (loss) available to Common Shares	<u>(\$0.34)</u>	<u>\$1.88</u>	<u>\$1.53</u>	<u>\$3.64</u>
<b>Diluted earnings (loss) per Common Share:</b>				
Continuing operations	(\$0.34)	\$1.91	\$1.51	\$3.67
Discontinued operations	-	(.01)	-	(.01)
Cumulative effect of accounting change	<u>-</u>	<u>(.05)</u>	<u>-</u>	<u>(.08)</u>
Net earnings (loss) available to Common Shares	<u>(\$0.34)</u>	<u>\$1.85</u>	<u>\$1.51</u>	<u>\$3.58</u>
Average number of Common Shares:				
Basic	77,335	73,626	77,060	73,396
Diluted	78,702	74,762	78,267	74,597
Cash dividends per Common Share	\$.125	\$.125	\$.375	\$.375

**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 on Securities	Total
<b>Balance at January 1, 2005</b>	76,634,204	\$1,222,507	\$ 976,340	\$231,700	\$2,430,547
Net earnings	-	-	118,070	-	118,070
Change in unrealized Comprehensive income(loss)	-	-	-	(138,000)	(138,000)
					(19,930)
Dividends on Common Stock	-	-	(28,859)	-	(28,859)
Shares issued:					
Exercise of stock options	947,138	25,518	-	-	25,518
Dividend reinvestment plan	144,303	4,214	-	-	4,214
Employee stock purchase plan	19,873	633	-	-	633
Retirement plan contributions	113,414	3,622	-	-	3,622
Deferred compensation distributions	7,374	222	-	-	222
Directors fees paid in stock	9,320	300	-	-	300
Shares tendered in option exercises	(401,784)	(6,415)	(6,015)	-	(12,430)
Capital transactions of subsidiaries	-	(7,850)	-	-	(7,850)
Other	-	6,995	-	-	6,995
<b>Balance at September 30, 2005</b>	<u>77,473,842</u>	<u>\$1,249,746</u>	<u>\$1,059,536</u>	<u>\$ 93,700</u>	<u>\$2,402,982</u>
<b>Balance at January 1, 2004</b>	73,056,085	\$1,108,840	\$ 664,721	\$302,600	\$2,076,161
Net earnings	-	-	267,340	-	267,340
Change in unrealized Comprehensive income	-	-	-	(69,600)	(69,600)
					197,740
Dividends on Common Stock	-	-	(27,506)	-	(27,506)
Shares issued:					
Exercise of stock options	872,499	22,083	-	-	22,083
Dividend reinvestment plan	6,151	167	-	-	167
Employee stock purchase plan	20,908	616	-	-	616
Retirement plan contributions	107,898	3,212	-	-	3,212
Deferred compensation distributions	34,218	977	-	-	977
Directors fees paid in stock	11,666	339	-	-	339
Shares tendered in option exercises	(428,750)	(6,529)	(6,605)	-	(13,134)
Other	-	(350)	-	-	(350)
<b>Balance at September 30, 2004</b>	<u>73,680,675</u>	<u>\$1,129,355</u>	<u>\$ 897,950</u>	<u>\$233,000</u>	<u>\$2,260,305</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>2005</u>	<u>2004</u>
<b>Operating Activities:</b>		
Net earnings	\$ 118,070	\$ 267,340
Adjustments:		
Cumulative effect of accounting change	-	5,593
Equity in net losses of investee	4,904	2,468
Minority interest	22,075	22,651
Depreciation and amortization	148,442	127,986
Annuity benefits	246,529	228,513
Realized gains on investing activities	(68,320)	(274,577)
Net purchases/sales of trading securities	12,047	(85,683)
Deferred annuity and life policy acquisition costs	(94,021)	(95,035)
Increase in reinsurance and other receivables	(38,456)	(125,520)
Decrease (increase) in other assets	(5,053)	70,936
Increase in insurance claims and reserves	753,862	409,598
Increase (decrease) in payable to reinsurers	(251,267)	80,797
Increase (decrease) in other liabilities	(12,626)	127,035
Other, net	18,395	13,423
	<u>854,581</u>	<u>775,525</u>
<b>Investing Activities:</b>		
Purchases of and additional investments in:		
Fixed maturity investments	(3,258,133)	(3,729,889)
Equity securities	(181,606)	(131,932)
Subsidiary	(17,500)	(10,382)
Real estate, property and equipment	(69,327)	(46,887)
Maturities and redemptions of fixed maturity investments	864,715	972,067
Sales of:		
Fixed maturity investments	1,331,269	2,370,684
Equity securities	202,968	48,958
Real estate, property and equipment	44,727	15,542
Cash and short-term investments of businesses acquired or sold, net	52,556	27,857
Increase in other investments	(9,615)	(16,667)
	<u>(1,039,946)</u>	<u>(500,649)</u>
<b>Financing Activities:</b>		
Fixed annuity receipts	632,465	523,968
Annuity surrenders, benefits and withdrawals	(688,416)	(534,302)
Net transfers from variable annuity assets	10,127	1,996
Additional long-term borrowings	14,716	195,008
Reductions of long-term debt	(28,342)	(8,482)
Repurchases of trust preferred securities	-	(188,961)
Issuances of Common Stock	11,558	7,411
Subsidiary's issuance of stock in public offering	40,391	-
Cash dividends paid on Common Stock	(24,645)	(27,339)
Other, net	(2,923)	(642)
	<u>(35,069)</u>	<u>(31,343)</u>
<b>Net Increase (Decrease) in Cash and Short-term Investments</b>	(220,434)	243,533
Cash and short-term investments at beginning of period	<u>861,742</u>	<u>593,552</u>
Cash and short-term investments at end of period	<u>\$ 641,308</u>	<u>\$ 837,085</u>

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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**A. Accounting Policies**

**Basis of Presentation** The accompanying consolidated financial statements for American Financial Group, Inc. ("AFG") and subsidiaries are unaudited; however, management believes that all adjustments (consisting only of normal recurring accruals unless otherwise disclosed herein) necessary for fair presentation have been made. The results of operations for interim periods are not necessarily indicative of results to be expected for the year. The financial statements have been prepared in accordance with the instructions to Form 10-Q and therefore do not include all information and footnotes necessary to be in conformity with 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** Fixed maturity securities and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses reported as a separate component of shareholders' equity. Fixed maturities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in investment income. 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 payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations. The most significant determinants of prepayments are the difference between interest rates on the underlying mortgages and current mortgage loan rates and the structure of the security. Other factors affecting prepayments include the size, type and age of underlying mortgages, the geographic location of the mortgaged properties and the creditworthiness of the borrowers. Variations from anticipated prepayments will affect the life and yield of these securities.

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 (included in realized gains (losses) on securities) and the cost basis of that investment is reduced.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

In 2003, the Financial Accounting Standards Board's ("FASB") Emerging Issues Task Force ("EITF") reached a final consensus on Issue 03-16, "Accounting for Investments in Limited Liability Companies" under which limited liability companies ("LLCs") are deemed to be the same as limited partnerships for which the equity method of accounting is generally required for ownership levels of "more than 3 to 5 percent." In accordance with EITF 03-16, the cumulative effect of changing from the cost to the equity method of accounting for AFG's investment in an LLC was recorded in the third quarter of 2004.

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

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

**Managed Investment Entity** From year-end 2003 through the first quarter of 2005, AFG consolidated a collateralized debt obligation ("CDO"). Since AFG had no right to use the CDO assets and the CDO liabilities could be extinguished only by using CDO assets, the assets and liabilities of the CDO were shown separate from AFG's other assets and liabilities in the Balance Sheet. Income and expenses of the CDO are shown separately in the Statement of Operations; related minority interest is included in "Minority Interest Expense." In the first half of 2005, the CDO liquidated its investment portfolio and distributed the proceeds to its senior debt and equity investors, including AFG.

**Goodwill** Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Goodwill is not amortized but is subject to an impairment test annually, or more frequently if an event occurs that indicates the goodwill may be impaired. AFG performs its annual impairment test in the fourth quarter.

**Insurance** As discussed under "Reinsurance" below, unpaid losses and loss adjustment expenses and unearned premiums have not been reduced for reinsurance recoverable.

**Reinsurance** 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. Payable to reinsurers includes ceded premiums retained by AFG's property and casualty insurance subsidiaries under contracts to fund ceded losses as they become due. AFG's insurance subsidiaries also assume reinsurance from other companies. Income on reinsurance assumed is recognized based on reports received from ceding companies.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Subsidiaries of AFG's 82%-owned subsidiary, Great American Financial Resources, Inc. ("GAFRI"), cede life insurance policies to a third party on a funds withheld basis whereby GAFRI retains the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance (including realized gains and losses) of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be marked to market) because the yield on the payables is based on specific blocks of the ceding companies' assets, rather than the overall creditworthiness of the ceding company. GAFRI determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. GAFRI classifies the securities related to these transactions as "trading." The mark to market on the embedded derivatives offsets the investment income recorded on the mark to market of the related trading portfolios.

**Deferred Policy Acquisition Costs ("DPAC")** Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies.

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

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

**Annuity, Supplemental Insurance and Life Acquisition Expenses** Annuity, supplemental insurance and life acquisition expenses on the Statement of Operations consists of amortization of DPAC related to the annuity, supplemental insurance and life businesses. This line item also includes certain marketing and commission costs of those businesses that are expensed as paid.

**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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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. Establishing reserves for asbestos and environmental claims involves considerably more judgment than other types of claims due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage.

Loss reserve liabilities are subject to the impact of changes in claim amounts and frequency and other factors. Changes in estimates of the liabilities for losses and loss adjustment expenses are reflected in the Statement of 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 the original projections of investment yields, mortality, morbidity and surrenders and include provisions for unfavorable deviations. Reserves established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

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

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

**Payable to Subsidiary Trusts** Certain subsidiaries have wholly-owned subsidiary trusts that issued preferred securities and, in turn, purchased a like amount of subordinated debt from their parent company. Interest and principal payments from the parent fund the respective trust obligations. AFG does not consolidate these subsidiary trusts because they are "variable interest entities" in which AFG is not considered to be the primary beneficiary. Accordingly, the subordinated debt due to the trusts is shown as a liability in the Balance Sheet and the related interest expense is shown in the Statement of Operations as "interest on subsidiary trust obligations."

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**Minority Interest** For balance sheet purposes, minority interest represents the interests of noncontrolling shareholders in consolidated entities. For income statement purposes, minority interest expense represents such shareholders' interest in the earnings of those entities.

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

Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

**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 Accounting Principles Board Opinion ("APB") 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.

The following table illustrates the effect on net earnings (loss) (in thousands) and earnings (loss) per share had compensation cost been recognized and determined based on the "fair values" at grant dates consistent with the method prescribed by SFAS No. 123.

For SFAS No. 123 purposes, the "fair value" of \$9.66 per option granted in the first nine months of 2005 and \$8.92 in the first nine months of 2004 was calculated using the Black-Scholes option pricing model and the following assumptions: expected dividend yield of 2%; expected volatility of 28% in 2005 and 29% in 2004; risk-free interest rate of 4.3% for 2005 and 3.7% for 2004; and expected option life of 8.4 years in 2005 and 7.5 years in 2004. There is no single reliable method to determine the actual value of options at grant date. Accordingly, actual value of the option grants may be higher or lower than the SFAS No. 123 "fair value."

	Three months ended		Nine months ended	
	September 30,		September 30,	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Net earnings (loss), as reported	(\$26,430)	\$138,200	\$118,070	\$267,340
Pro forma stock option expense, net of tax	<u>(1,875)</u>	<u>(1,602)</u>	<u>(5,614)</u>	<u>(4,810)</u>
Adjusted net earnings (loss)	<u>(\$28,305)</u>	<u>\$136,598</u>	<u>\$112,456</u>	<u>\$262,530</u>
Earnings (loss) per share (as reported):				
Basic	(\$0.34)	\$1.88	\$1.53	\$3.64
Diluted	(\$0.34)	\$1.85	\$1.51	\$3.58
Earnings (loss) per share (adjusted):				
Basic	(\$0.37)	\$1.86	\$1.46	\$3.58
Diluted	(\$0.36)	\$1.84	\$1.45	\$3.54

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which revises SFAS 123 and eliminates the use of the intrinsic value method prescribed by APB 25. Under SFAS 123(R), companies must recognize compensation expense for all new share-based awards (including employee stock options), and the nonvested portions of prior awards, based on their fair value at the date of grant. AFG expects to implement the new standard on January 1, 2006, on a prospective basis. After that date, compensation expense will be recognized for all share-based grants over their respective vesting periods. While AFG currently uses the Black-Scholes pricing model to measure the fair value of employee stock options for purposes of disclosing pro forma earnings, the use of other models are also permitted under SFAS No. 123(R). AFG has not yet determined which model it will use to measure the fair value of future stock option grants, and accordingly, cannot quantify the exact impact of implementing the new standard.

**Benefit Plans** AFG provides retirement benefits to qualified employees of participating companies through the AFG Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Employees have been permitted to direct the investment of their contributions to independently managed investment funds, while Company contributions are initially invested primarily in securities of AFG and affiliates. Employees may re-direct the investment of their vested retirement fund account balances from securities of AFG and its affiliates to independently managed investment funds. The plan sells small amounts of AFG securities each day in a program intended to keep funds available for requested transfers to other funds. As of September 30, 2005, the Plan held 9% of AFG's outstanding Common Stock. Company contributions are expensed in the year for which they are declared.

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

**Earnings Per Share** Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes the following dilutive effect of common stock options: third quarter of 2005 and 2004 - 1,367,000 shares and 1,136,000 shares; nine months of 2005 and 2004 - 1,207,000 shares and 1,201,000 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.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**B. Acquisitions and Sales of Subsidiaries**

**Farmers Crop Insurance Alliance, Inc.** On September 30, 2005, AFG acquired the multi-peril crop insurance and the crop hail insurance business written through Farmers Crop Insurance Alliance, Inc. for \$17.5 million in cash. AFG will pay additional amounts of up to 10% of annual premiums over the next three years based on certain customer retention criteria. Approximately \$16.5 million of the initial Farmers Crop purchase price, as well as any future payments (not expected to exceed \$30 million) made based on customer retention, will be recorded as intangible renewal rights and amortized over four years on a straight-line basis. The business acquired generated gross written premiums of approximately \$504 million in 2004. While AFG expects to retain a majority of this business, there is uncertainty as to the amount of premiums that ultimately will be retained due to the departure of several Farmers' employees in the months preceding the acquisition.

**Transport Insurance Company** In November 2004, AFG completed the sale of Transport Insurance Company, an inactive property and casualty subsidiary with only run-off liabilities. Transport's results for 2004 are reflected as discontinued in the Statement of Operations.

**National Health Annuity Business** In May 2004, GAFRI acquired the fixed annuity business of National Health Insurance Company (over 30,000 policies), increasing both annuity benefits accumulated and cash and investments by approximately \$750 million.

**C. Subsidiary's Initial Public Offering** An AFG majority-owned subsidiary, National Interstate Corporation ("NIC"), issued 3.4 million of its common shares in a February 2005 initial public offering. NIC used \$15 million of the \$40.4 million in proceeds to repay a loan to an AFG subsidiary and the balance for general corporate purposes. At September 30, 2005, AFG owned approximately 54% of NIC's common stock.

**D. Segments of Operations** AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity, supplemental insurance and life products, and (iii) other, which includes holding company costs and the operations of a CDO that AFG managed.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes inland and ocean marine, agricultural-related business and commercial automobile, (ii) Specialty casualty, which includes executive and professional liability, umbrella and excess liability and excess and surplus, (iii) Specialty financial, which includes fidelity and surety bonds and collateral protection, and (iv) California workers' compensation. AFG's annuity, supplemental insurance and life business markets primarily retirement annuities and various forms of supplemental insurance and life products. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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

	Three months ended September 30,		Nine months ended September 30,	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
<b>Revenues (a)</b>				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	\$ 270,662	\$ 166,466	\$ 640,319	\$ 436,324
Specialty casualty	183,794	181,781	550,858	537,289
Specialty financial	91,586	87,884	270,008	271,734
California workers' compensation	88,128	90,937	262,029	251,164
Other	16,496	19,513	49,507	57,310
Other lines	695	2,715	3,074	11,796
	<u>651,361</u>	<u>549,296</u>	<u>1,775,795</u>	<u>1,565,617</u>
Investment income	71,336	64,794	209,821	192,221
Realized gains	7,561	179,135	16,857	209,088
Other	76,636	50,009	179,666	143,684
	<u>806,894</u>	<u>843,234</u>	<u>2,182,139</u>	<u>2,110,610</u>
Annuities, supplemental insurance and life:				
Investment income	141,951	136,682	428,685	396,729
Realized gains	3,008	44,381	16,635	51,282
Life, accident and health premiums	91,811	85,929	276,256	263,807
Other	38,963	35,816	97,232	81,779
	<u>275,733</u>	<u>302,808</u>	<u>818,808</u>	<u>793,597</u>
Other	10,149	7,479	18,461	25,020
	<u>\$1,092,776</u>	<u>\$1,153,521</u>	<u>\$3,019,408</u>	<u>\$2,929,227</u>
<b>Operating Profit (Loss)</b>				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	\$ 5,242	\$ 769	\$ 72,701	\$ 43,644
Specialty casualty	19,475	2,264	33,709	13,934
Specialty financial	(9,253)	(4,566)	(21,159)	(6,826)
California workers' compensation	29,406	9,416	63,970	21,488
Other	(1,738)	(4,289)	(2,295)	(4,171)
Other lines (b)	(177,487)	(3,099)	(180,333)	(7,805)
	<u>(134,355)</u>	<u>495</u>	<u>(33,407)</u>	<u>60,264</u>
Investment income, realized gains and other	98,397	232,931	230,560	374,819
	<u>(35,958)</u>	<u>233,426</u>	<u>197,153</u>	<u>435,083</u>
Annuities, supplemental insurance and life (c)	26,731	71,818	94,507	123,638
Other (d)	(15,075)	(72,660)	(62,034)	(115,199)
	<u>(\$ 24,302)</u>	<u>\$ 232,584</u>	<u>\$ 229,626</u>	<u>\$ 443,522</u>

- (a) Revenues include sales of products and services as well as other income earned by the respective segments.
- (b) Includes a third quarter 2005 charge of \$179.3 million to increase asbestos and environmental reserves.
- (c) Includes a third quarter 2005 charge of \$9.5 million related to environmental liabilities at GAFRI's former manufacturing operations.
- (d) Includes holding company expenses. The third quarter of 2004 includes a charge of \$52 million resulting from the settlement of litigation.

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**E. Deferred Policy Acquisition Costs** Included in deferred policy acquisition costs in AFG's Balance Sheet are \$66.0 million and \$72.7 million at September 30, 2005, and December 31, 2004, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity, supplemental insurance and life business. The PVFP amounts are net of \$80.7 million and \$73.2 million of accumulated amortization. Amortization of the PVFP was \$1.6 million in the third quarter and \$7.5 million in the first nine months of 2005 and \$1.7 million in the third quarter and \$5.2 million in the first nine months of 2004, respectively.

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

	September 30, <u>2005</u>	December 31, <u>2004</u>
<b>Holding Company:</b>		
AFG 7-1/8% Senior Debentures due April 2009	\$297,016	\$296,843
AFG Senior Convertible Notes due June 2033	189,857	189,857
AFG 7-1/8% Senior Debentures due February 2034	115,000	115,000
AFG 7-1/8% Senior Debentures due December 2007	61,993	75,100
Other	<u>3,764</u>	<u>8,283</u>
	<u>\$667,630</u>	<u>\$685,083</u>
<b>Subsidiaries:</b>		
GAFRI 7-1/2% Senior Debentures due November 2033	\$112,500	\$112,500
GAFRI 6-7/8% Senior Notes due June 2008	100,000	100,000
GAFRI 7-1/4% Senior Debentures due January 2034	86,250	86,250
Notes payable secured by real estate	33,243	26,471
APU 10-7/8% Subordinated Notes due May 2011	8,139	8,181
Other	<u>8,988</u>	<u>10,188</u>
	<u>\$349,120</u>	<u>\$343,590</u>

At September 30, 2005, sinking fund and other scheduled principal payments on debt for the balance of 2005 and the subsequent five years were as follows (in millions):

	<u>Holding Company</u>	<u>Subsidiaries</u>	<u>Total</u>
2005	\$ -	\$ .5	\$ .5
2006	-	19.7	19.7
2007	62.8	.3	63.1
2008	-	100.3	100.3
2009	298.0	.4	298.4
2010	-	2.1	2.1

GAFRI has entered into interest rate swaps that effectively convert its 6-7/8% Senior Notes to a floating rate of 3-month LIBOR plus 2.9% (effective rate of approximately 6.8% at September 30, 2005 and 5.4% at December 31, 2004). The swaps realign GAFRI's mix of floating and fixed rate debt.

AFG's Senior Convertible Notes were issued at a price of 37.153% of the principal amount due at maturity. Interest is payable semiannually at a rate of 4% of issue price per year through June 2008, after which interest at 4% annually will be accrued and added to the carrying value of the Notes. The Notes are redeemable at AFG's option at any time on or after June 2, 2008, at accreted value ranging from \$371.53 per Note at June 2, 2008 to \$1,000 per Note at maturity. Generally, holders may convert each Note into 11.5016 shares of AFG Common Stock (at \$32.30 per share currently) (i) if the average market price of AFG Common Stock to be received upon conversion exceeds 120% of the accreted value (\$38.76 per share currently), (ii) if the credit rating of the Notes is

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

significantly lowered, or, (iii) if AFG calls the notes for redemption. AFG intends to deliver cash in lieu of Common Stock upon conversion of the Notes; accordingly, shares issuable upon conversion of the Notes are not treated as dilutive.

- G. Payable to Subsidiary Trusts (Issuers of Preferred Securities)** The preferred securities supported by the payable to subsidiary trusts consisted of the following (in thousands):

Date of Issuance	Issue (Maturity Date)	Amount Outstanding		Optional Redemption Dates
		9/30/05	12/31/04	
March 1997	GAFRI 8-7/8% Pfd (2027)	\$42,800	\$42,800	On or after 3/1/2007
May 2003	GAFRI 7.35% Pfd (2033)	20,000	20,000	On or after 5/15/2008
May 2003	NIC Variable Pfd (2033)	15,000	15,000	On or after 5/23/2008

NIC and GAFRI effectively provide unconditional guarantees of their respective trusts' obligations.

- H. Shareholders' Equity** 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.

**Stock Incentive Plans** Under AFG's 2005 Stock Incentive Plan, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. This plan will replace AFG's existing stock option plan once the remaining 220,096 shares authorized under such plan have been granted. At September 30, 2005, there were 12.4 million shares of AFG Common Stock reserved for issuance under AFG's stock incentive plans. As of that date, options for 7.1 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.

- I. Income Taxes** AFG's effective tax rate increased in 2005 due primarily to taxes recorded on the difference between AFG's book and tax basis in its investment in subsidiaries not included in the AFG tax group. In addition, the provision for income taxes in the third quarter of 2005 includes a \$4.3 million charge for the settlement of certain prior year tax issues with the IRS.

The American Jobs Creation Act of 2004 provides a special one-time dividends received deduction on the repatriation of certain foreign earnings. Through October 2005, Great American Life Assurance Company of Puerto Rico paid \$40 million in dividends to GAFRI. Deferred taxes had previously been accrued on these earnings. While AFG is still evaluating whether it will remit any additional qualified foreign earnings under this provision in 2005, it does not believe the impact of any such election will be material to its results of operations.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

- J. **Equity in Net Losses of Investee** Equity in net losses of investee represents AFG's share of the losses from a manufacturing business. Equity in net losses of investee for the first nine months of 2005 includes a second quarter impairment writedown of \$3.9 million aftertax.
- K. **Commitments and Contingencies** Except for the items discussed in Management's Discussion and Analysis - "Asbestos and Environmental Reserve Charge" and "Other Operating and General Expenses", there have been no significant changes to the matters discussed and referred to in Note O - "Commitments and Contingencies" of AFG's 2004 Annual Report on Form 10-K.
- L. **Subsequent Event** In November 2005, AFG announced its intent to sell its 15% interest in The Cincinnati Reds, LLC. If the transaction is completed under the terms announced by the Reds, AFG would expect to recognize a pretax gain of approximately \$23 million. See Management's Discussion and Analysis - "Real Estate Operations" for anticipated fourth quarter gains on real estate sales.

# AMERICAN FINANCIAL GROUP, INC. 10-Q

## ITEM 2

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

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#### **FORWARD-LOOKING STATEMENTS**

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words such as "anticipates", "believes", "expects", "estimates", "intends", "plans", "seeks", "could", "may", "should", "will" or the negative version of those words or other comparable terminology. 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; recoverability of asset values; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate increases; and improved loss experience.

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

- changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;
- regulatory actions;
- changes in the legal environment affecting AFG or its customers;
- tax law changes;
- levels of natural catastrophes, terrorist events (including any nuclear, biological, chemical, or radiological events), incidents of war and other major losses;
- development of insurance loss reserves and other reserves, particularly with respect to amounts associated with asbestos and environmental claims;
- the unpredictability of possible future litigation if certain settlements do not become effective;
- trends in mortality and morbidity;
- availability of reinsurance;
- ability of reinsurers to pay their obligations;
- competitive pressures, including the ability to obtain rate increases; and
- changes in debt and claims paying ratings.

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

#### **OVERVIEW**

##### **Financial Condition**

AFG is organized as a holding company with almost all of its operations being conducted by subsidiaries. AFG, however, has continuing cash needs for administrative expenses, the payment of principal and interest on borrowings,

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

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.

#### **Results of Operations**

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance, focusing on specialized commercial products for businesses, and in the sale of retirement annuities and supplemental insurance and life products.

AFG reported a net loss for the third quarter of 2005 of \$26.4 million or \$.34 per share (diluted), compared to net earnings of \$138.2 million or \$1.85 per share recorded in the comparable period in 2004. Significantly improved underwriting results in AFG's Specialty property and casualty insurance operations and gains on the sale of Illinois coal assets were more than offset by a charge to strengthen asbestos and environmental ("A&E") reserves. Additionally, in the 2004 quarter, AFG reported a significant gain on the sale of Provident Financial Group, partially offset by a litigation charge.

Net earnings for the first nine months of 2005 were \$118.1 million or \$1.51 per share, compared to \$267.3 million or \$3.58 per share recorded in the comparable period in 2004. The decline reflects the items discussed above.

#### **CRITICAL ACCOUNTING POLICIES**

Significant accounting policies are summarized in Note A to the financial statements. The preparation of financial statements requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future. Management believes that the establishment of insurance reserves, especially asbestos and environmental-related reserves, the recoverability of annuity and life deferred policy acquisition costs, and the determination of "other than temporary" impairment on investments are the areas where the degree of judgment required to determine amounts recorded in the financial statements make the accounting policies critical. For a discussion of these policies, see *Management's Discussion and Analysis - "Critical Accounting Policies" in AFG's 2004 Form 10-K.*

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### 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 on a consolidated basis is shown below (dollars in millions).

	September 30,	December 31,	
	2005	2004	2003
Consolidated debt (1)	\$1,095	\$1,106	\$1,102
Total capital (2)	3,696	3,575	3,187
Ratio of debt to total capital	29.6%	30.9%	34.6%

- (1) Includes payable to subsidiary trusts.  
(2) Includes consolidated debt, minority interest and shareholders' equity (excluding unrealized gains (losses) related to fixed maturity investments).

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 1.73 for the nine months ended September 30, 2005 (2.32 excluding the A&E charge) and 2.43 (1.91 excluding the Provident gain) for the entire year of 2004. Excluding annuity benefits, this ratio was 4.27 (6.96 excluding the A&E charge) and 7.07 (4.85 excluding the Provident gain), respectively. Although the ratio excluding interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

#### **Sources of Funds**

**Parent Holding Company Liquidity** Management believes AFG has sufficient resources to meet its parent holding company liquidity requirements, primarily through funds generated by its subsidiaries' operations. If funds provided by subsidiaries through dividends and tax payments are insufficient to meet fixed charges and other holding company costs in any period, AFG could utilize parent company cash (approximately \$100 million at September 30, 2005) or generate cash through borrowings, sales of securities or other assets, or similar transactions.

In November 2004, AFG replaced its existing credit line with a \$300 million, four-year revolving credit facility. Amounts borrowed bear interest at rates ranging from 1% to 2% over LIBOR based on AFG's credit rating. No amounts have been borrowed under this agreement. This credit agreement provides ample liquidity and can be used to obtain funds for operating subsidiaries or, if necessary, for the parent company.

Under a currently effective shelf registration statement, AFG can offer up to an aggregate of \$517 million in additional equity or debt securities including 2.3 million shares of common stock remaining under a 2004 equity distribution agreement with UBS Securities LLC. The shelf registration provides AFG with greater flexibility to access the capital markets from time to time as market and other conditions permit.

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

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

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

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

As discussed in Note C, National Interstate Corporation issued 3.4 million shares of its common stock in a February 2005 initial public offering for net proceeds of \$40.4 million.

In August 2004, GAFRI replaced its existing credit agreement with a \$150 million four-year revolving credit facility; this facility was increased to \$165 million in April 2005. Amounts borrowed bear interest at rates ranging from 1% to 2% over LIBOR based on GAFRI's credit rating. No amounts have been borrowed under this agreement. In addition, GAFRI can offer approximately \$250 million in additional equity or debt securities under a currently effective shelf registration.

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

**Investments** AFG's investment portfolio at September 30, 2005, contained \$14.2 billion in "Fixed maturities" classified as available for sale and \$520 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 September 30, 2005, AFG had pretax net unrealized gains of \$142.3 million on fixed maturities and \$49.7 million on other stocks.

Approximately 94% of the fixed maturities held by AFG at September 30, 2005, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and noninvestment grade. Management believes that a high quality investment portfolio should generate a stable and predictable investment return.

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.

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

Summarized information for the unrealized gains and losses recorded in AFG's Balance Sheet at September 30, 2005, is shown in the following table (dollars in millions). Approximately \$68 million of available for sale "Fixed maturities" and \$15 million of "Other stocks" had no unrealized gains or losses at September 30, 2005.

	<u>Securities With Unrealized Gains</u>	<u>Securities With Unrealized Losses</u>
<u>Available for sale Fixed Maturities</u>		
Market value of securities	\$ 6,990	\$ 7,172
Amortized cost of securities	\$ 6,737	\$ 7,283
Gross unrealized gain (loss)	\$ 253	(\$ 111)
Market value as % of amortized cost	104%	98%
Number of security positions	1,328	981
Number individually exceeding \$2 million gain or loss	3	-
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Banks, savings and credit institutions	\$40.6	(\$ 5.9)
Gas and electric services	35.0	(3.1)
Mortgage-backed securities	19.1	(49.4)
U.S. Government and government agencies	14.3	(15.7)
Telephone communications	14.9	(1.9)
State and municipal	13.1	(7.4)
Percentage rated investment grade	92%	96%

The table below sets forth the scheduled maturities of AFG's available for sale fixed maturity securities at September 30, 2005, based on their market values. Asset-backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

<u>Maturity</u>	<u>Securities With Unrealized Gains</u>	<u>Securities With Unrealized Losses</u>
One year or less	4%	2%
After one year through five years	21	25
After five years through ten years	44	21
After ten years	<u>14</u>	<u>5</u>
	83	53
Mortgage-backed securities	<u>17</u>	<u>47</u>
	<u>100%</u>	<u>100%</u>

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

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

AFG realized aggregate losses of \$4.5 million during the first nine months of 2005 on \$132.7 million in sales of fixed maturity securities (five issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2004. The market value of two of the securities increased an aggregate of \$677,000 from December 31 to the sale date. The market value of the other three securities decreased an aggregate of \$652,000 from December 31 to the sale date.

Although AFG had the ability to continue holding these investments, its intent to hold them changed due primarily to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular industry, or to modify asset allocation within the portfolio.

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

	<u>Aggregate Market Value</u>	<u>Aggregate Unrealized Gain (Loss)</u>	<u>Market Value as % of Cost Basis</u>
<u>Fixed Maturities at September 30, 2005</u>			
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 (135 issues)	\$1,769	\$124	108%
Less than \$500,000 (1,193 issues)	<u>5,221</u>	<u>129</u>	103
	<u>\$6,990</u>	<u>\$253</u>	104%
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 (42 issues)	\$1,256	(\$ 36)	97%
Less than \$500,000 (939 issues)	<u>5,916</u>	<u>( 75)</u>	99
	<u>\$7,172</u>	<u>(\$111)</u>	98%

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

	<u>Aggregate Market Value</u>	<u>Aggregate Unrealized Gain (Loss)</u>	<u>Market Value as % of Cost Basis</u>
<u>Fixed Maturities with Unrealized Losses at September 30, 2005</u>			
<b>Investment grade with losses for:</b>			
One year or less (789 issues)	\$5,825	(\$ 73)	99%
Greater than one year (135 issues)	<u>1,081</u>	<u>(32)</u>	97
	<u>\$6,906</u>	<u>(\$105)</u>	99%
<b>Non-investment grade with losses for:</b>			
One year or less (43 issues)	\$ 231	(\$ 4)	98%
Greater than one year (14 issues)	<u>35</u>	<u>(2)</u>	95
	<u>\$ 266</u>	<u>(\$ 6)</u>	98%

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 2004 Form 10-K.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

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** Management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and American Premier's contingencies arising out of its former operations. See *Management's Discussion and Analysis - "Uncertainties" in AFG's 2004 Form 10-K.*

See Management's Discussion and Analysis - "Asbestos and Environmental Charge" for a discussion of AFG's third quarter 2005 charge to increase its A&E reserves.

### **RESULTS OF OPERATIONS**

**General** Results of operations as shown in the accompanying financial statements are prepared in accordance with generally accepted accounting principles.

AFG reported an operating loss before income taxes of \$24.3 million in the third quarter of 2005 compared to operating earnings before income taxes of \$232.6 million in the 2004 quarter. A \$39.5 million improvement in Specialty property and casualty insurance underwriting results compared to the 2004 quarter and \$30.9 million in pretax gains from the sale of Illinois coal assets were more than offset by \$189 million in pretax charges resulting from strengthening A&E reserves within AFG's run-off operations. The 2005 results include \$40 million in pretax losses from hurricanes Katrina and Rita compared to \$35 million in hurricane losses in the 2004 period. Results for the 2004 quarter include a \$214 million pretax gain on the sale of Provident Financial Group securities and a \$52 million litigation charge.

Nine month pretax operating earnings decreased \$213.9 million compared to 2004 reflecting a \$78.9 million improvement in Specialty property and casualty insurance underwriting results which was more than offset by the net effect of the other third quarter items discussed above.

**Property and Casualty Insurance - Underwriting** AFG reports its Specialty insurance business in the following sub-segments: (i) Property and transportation, which includes inland and ocean marine, agricultural-related business and commercial automobile, (ii) Specialty casualty, which includes executive and professional liability, umbrella and excess liability and excess and surplus, (iii) Specialty financial, which includes fidelity and surety bonds and collateral protection, and (iv) California workers' compensation.

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



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

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

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
<u>Gross Written Premiums (GAAP)</u>				
Specialty:				
Property and transportation	\$ 496.8	\$ 527.7	\$1,087.1	\$1,105.8
Specialty casualty	359.6	364.8	1,080.7	1,116.4
Specialty financial	133.1	114.7	367.6	342.5
California workers' compensation	93.5	97.3	289.8	283.7
Other	(2.5)	1.7	1.2	.2
Total Specialty	<u>\$1,080.5</u>	<u>\$1,106.2</u>	<u>\$2,826.4</u>	<u>\$2,848.6</u>
<u>Net Written Premiums (GAAP)</u>				
Specialty:				
Property and transportation	\$ 291.0	\$ 172.4	\$ 728.8	\$ 525.3
Specialty casualty	192.3	189.4	567.4	581.5
Specialty financial	107.9	91.5	294.7	277.5
California workers' compensation	84.2	87.4	260.5	252.0
Other	16.4	19.8	48.4	50.2
Total Specialty	<u>\$ 691.8</u>	<u>\$ 560.5</u>	<u>\$1,899.8</u>	<u>\$1,686.5</u>
<u>Combined Ratios (GAAP)(a)</u>				
Specialty:				
Property and transportation (b)	98.1%	99.5%	88.7%	90.0%
Specialty casualty	89.4	98.7	93.9	97.4
Specialty financial (c)	110.1	105.2	107.8	102.5
California workers' compensation	66.7	89.7	75.5	91.5
Other	110.6	122.0	104.6	107.3
Total Specialty (d)	93.3%	99.4%	91.8%	95.6%

- (a) AFG's aggregate combined ratio, including other (primarily discontinued) lines, was 120.6% and 99.9% for the three months ended September 30, 2005 and 2004 and 101.8% and 96.2% for the nine months ended September 30, 2005 and 2004, respectively. The aggregate ratio includes 27.5 points and 10.1 points, respectively, for the three and nine month periods of 2005 relating to the A&E charge.
- (b) Includes the effect of hurricane losses for the 2005 three and nine month periods of 10.8 points and 4.6 points, respectively, and for the 2004 three and nine month periods of 16.6 points and 6.3 points, respectively.
- (c) Includes the effect of hurricane losses for the 2005 three and nine month periods of 7.1 points and 2.4 points, respectively, and for the 2004 three and nine month periods of 2.9 points and 0.9 points, respectively.
- (d) Excludes discontinued operations. Includes the effect of hurricane losses of 6.2% and 2.3%, respectively, for the three and nine month periods of 2005 and 6.4% and 2.3%, respectively, for the three and nine month periods of 2004.

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

Gross written premiums of the Specialty business were 2% lower for the third quarter and 1% lower for the nine months compared to the same periods in 2004. While certain operations experienced volume growth, overall premium levels for the Specialty insurance operations continued to be impacted by the moderating rate environment. Overall average rates in the 2005 third quarter were down slightly compared to the same period a year earlier. Net written premiums increased 23% for the third quarter and 13% for the nine months over the comparable 2004 periods, reflecting continued increases in retention of premiums under reinsurance agreements.

**Property and transportation** gross written premiums decreased 6% for the third quarter and 2% for the nine months compared to the 2004 periods, due primarily to the effect of lower commodity prices earlier in the year which were used to establish the insured value of crop insurance coverages and lower volume resulting from competitive pricing within the excess property insurance operations. Net written premiums increased 69% and 39% during the third quarter and nine months compared to the 2004 periods reflecting a reduction in reinsurance ceded, principally in the crop insurance and inland marine operations. Excluding the effect of hurricanes in both periods, the combined ratio for the 2005 quarter was 4.4 points higher than the 2004 third quarter, reflecting primarily the exceptionally strong profitability reported by the crop insurance business in the 2004 period. This group's combined ratio for the first nine months of 2005 was comparable to the 2004 period, excluding the effects of hurricane losses in both years.

**Specialty casualty** gross written premiums decreased 1% in the third quarter and 3% in the first nine months compared to the same periods in 2004 while net written premiums increased slightly in the third quarter and decreased 2% in the nine months, reflecting lower volume due to the effect of softer pricing in many of the casualty markets. The combined ratio improved 9.3 points and 3.5 points, respectively, for the third quarter and first nine months of 2005 compared to the 2004 periods due to a decrease in unfavorable prior year development of loss reserves, particularly in the executive and professional liability business.

**Specialty financial** gross and net written premiums grew 16% and 18%, respectively, for the third quarter of 2005 compared to the same period in 2004, due primarily to increases in the leased equipment lines and surety business. Gross and net written premiums for the first nine months of 2005 were 7% and 6% higher than the 2004 period, reflecting growth in the dealer services and fidelity and crime businesses in the 2005 first quarter. This group's combined ratio in the third quarter of 2005 included 7.1 points from hurricane losses compared to 2.9 points in the 2004 third quarter. Although most operations continued to generate underwriting profits, losses from the residual value business continue to adversely impact this group's results.

**California workers' compensation** gross and net written premiums for the 2005 quarter were 4% below the 2004 quarter due to the lower rate environment. Through the first nine months of 2005, gross written premiums grew 2% and net written premiums grew 3% compared to 2004 as volume growth and retention more than offset the lower rates. The combined ratio for the third quarter and nine months improved 23 points and 16 points over the 2004 periods, respectively. Rate decreases in California, which are responsive to the improving claims environment, averaged 26% for the 2005 third quarter and 14% for the first nine months of 2005. Management believes that the group's current rates are adequate to continue to generate favorable returns.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

**Asbestos and Environmental Reserve Charge** AFG recently completed a comprehensive study of its asbestos and environmental exposures relating to the run-off operations of its property and casualty group. AFG has undertaken periodic reviews of its A&E reserves with the aid of an international independent actuarial firm and specialty outside counsel. As a result of its study, AFG recorded a 2005 third quarter pre-tax charge of \$179 million, net of \$26 million in reinsurance recoverables. This charge resulted in an increase in asbestos reserves of \$124 million and environmental and other mass tort reserves of \$55 million. At September 30, 2005, AFG's A&E reserves were \$475 million, net of reinsurance recoverables. At that date, AFG's three year survival ratio was 21.8 times paid losses for the asbestos reserves and 13.2 times paid losses for the total A&E reserves (16.8 and 10.6 times paid losses, respectively, excluding amounts associated with the 2003 settlement of asbestos related coverage litigation for A.P. Green Industries).

This study reviewed open and closed A&E claims at June 30, 2005. With respect to asbestos, it considered both direct insurance and assumed reinsurance, products and non-products exposure, paid claims history, the pattern of new claims, settlements and projected development. As has been reported by others, the asbestos legal climate remains very difficult to predict. While some progress has been made in state asbestos tort reform, that progress has been somewhat offset by increased claims costs, increased defense costs, the assertion of non-products theories and an increasing number of claims against small to mid-sized insureds.

A primary driver of the increase in AFG's asbestos reserves is the use by independent actuaries of evolving methodologies, including developing parameters for estimating loss adjustment expenses and reducing reliance on extrapolation techniques. In addition, the independent actuaries have indicated that their views have evolved regarding estimation of the potential exposure for both products and non-products claims. In the actuaries' view, this refined approach has increased estimates of the company's indicated ultimate losses. The estimates of industry ultimate losses and AFG's historic premium market share have not changed since the 2001 study. In addition, there has been no significant change in AFG's payment patterns. In the 2005 study, the actuaries also have given additional weight to claims associated with peripheral defendants bringing direct insurance claims. While no single claim presents an unduly large exposure, the increase in the number of direct insurance claims from peripheral defendants has increased the projections of future defense cost and loss exposure.

While tort reform is helping in some jurisdictions, the legal climate in many jurisdictions continues to deteriorate, with larger verdict values being experienced. Expanding coverage interpretations by some courts also has led to increased exposure to some policies in certain jurisdictions.

With respect to the environmental claims, the study considered both direct insurance and assumed reinsurance, projected exposure at both National Priorities List ("NPL") sites and non-NPL sites, historic payment patterns, patterns of new claims, settlements and projected development. The increase in environmental reserves is primarily due to an increase in clean up costs at certain sites above prior expectations and a recent unexpected increase in the number of new claims that have been reported to the Company. In addition, projected development on a few claims exceeded estimates in the previous 2001 study.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

Establishing reserves for A&E claims relating to policies and participations in reinsurance treaties and former operations is subject to uncertainties that are significantly greater than those presented by other types of claims. For further discussion, see *Management's Discussion and Analysis - "Uncertainties"* in AFG's 2004 Form 10-K.

**Investment Income** The increase in investment income for the third quarter and first nine months of 2005 compared to the 2004 periods reflects an increase in average cash and investments of 8% for the quarter and 11% for the nine months, partially offset by slightly lower average yields on fixed maturity investments.

**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.

In July 2004, AFG received common and preferred shares equivalent to 8.1 million common shares of National City Corporation in exchange for its ownership interest in Provident Financial Group and realized a \$214.3 million pretax gain on the transaction.

Realized gains on securities include provisions for other than temporary impairment of securities still held as follows: third quarter of 2005 and 2004 - \$3.9 million and \$5.1 million; nine months of 2005 and 2004 - \$11.5 million and \$13.2 million, respectively.

**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 Operations as shown below (in millions).

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Other income	\$65.9	\$34.6	\$124.6	\$80.4
Other operating and general expenses	25.1	24.5	68.4	60.7
Interest charges on borrowed money	.4	.5	1.4	1.5
Minority interest expense, net	.9	1.3	2.0	2.2

The increase in income from real estate operations reflects a \$30.9 million pretax gain on the sale of Illinois coal reserves and to a lesser extent, acquisitions of new properties. Other income also includes net pretax gains on the sale of other real estate assets of \$1.1 million in the third quarter and \$10.1 million for the first nine months of 2005 and \$3.9 million and \$10.4 million for the 2004 periods.

**Fourth Quarter Real Estate Sales** AFG has a definitive agreement to sell its remaining coal interests in Ohio and Pennsylvania and expects to record a pretax gain on the sale of approximately \$26 million in the 2005 fourth quarter. In addition, on October 13, 2005, GAFRI completed the sale of the Driskill Hotel in Austin, Texas and expects to recognize a pretax gain of approximately \$18 million, after transaction costs and the write-off of certain deferred annuity acquisition costs associated with the gain recognition.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

**Other Income** Other income increased \$35 million (39%) for the third quarter and \$61.7 million (26%) for the first nine months of 2005 compared to 2004 due primarily to the increased income from real estate operations discussed above and, to a lesser extent, an increase in revenues earned by AFG's warranty business (\$4.3 million and \$11.8 million higher for the quarter and nine months).

**Annuity Benefits** Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. On its deferred annuities (annuities in the accumulation phase), GAFRI generally credits interest to policyholders' accounts at their current stated interest rates. Furthermore, for "two-tier" deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather than surrendered), GAFRI accrues additional reserves for (i) accrued persistency and premium bonuses and (ii) excess benefits expected to be paid on future deaths and annuitizations. Changes in crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect this accrual.

Historically, GAFRI has been able to react to changes in market interest rates and maintain a desired interest rate spread. Significant changes in projected investment yields could result in charges (or credits) to earnings in the period the projections are modified.

Annuity benefits in the third quarter of 2005 were comparable to the third quarter of 2004 as an increase in reserves due to new business was offset by lower average crediting rates. Annuity benefits for the first nine months of 2005 increased \$18.0 million (8%) compared to the same period in 2004 reflecting a full nine months of activity on the block of annuity policies acquired in May 2004.

**Annuity, Supplemental Insurance and Life Acquisition Expenses** Annuity and life acquisition expenses include amortization of annuity and life, accident and health deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Annuity, supplemental insurance and life acquisition expenses also include amortization of the present value of future profits of businesses acquired.

The vast majority of GAFRI's DPAC asset relates to its fixed annuity, variable annuity and life insurance lines of business. GAFRI's actuarial assumptions include an assumed reinvestment rate of 5.5% in 2005 increasing ratably to an ultimate assumed reinvestment rate of 7.0%. If the current interest rate environment persists through the end of the year, including a flattened yield curve, GAFRI may be required to write-off DPAC related to its fixed annuity operations. In addition, continued spread compression, decreases in the stock market and adverse mortality could also lead to write-offs of DPAC in the future. Any potential write-off of DPAC is not expected to have a material impact on the company's liquidity or results of operations.

**Interest Expense** AFG has generally financed its borrowings on a long-term basis, which has resulted in higher current costs.

**Interest on Subsidiary Trust Obligations** Interest charges decreased \$2.7 million for the first nine months of 2005 compared to 2004 due to the retirement of trust preferred securities in the 2004 first quarter.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

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

**Other Operating and General Expenses** Other operating and general expenses for the third quarter of 2005 include a \$9.5 million pretax charge to increase reserves related to environmental liabilities at GAFRI's former manufacturing operations. In 2004, this expense includes a \$52 million third quarter charge based on APU's settlement of litigation related to environmental clean-up costs at a former railroad site and a \$4 million goodwill write-off in the annuity and life operations. Excluding these items, other operating and general expenses decreased \$3.1 million (3%) for the third quarter and increased \$16.8 million (5%) for the first nine months of 2005 compared to the 2004 periods. The increase for the nine month period reflects increased expenses in both the real estate operations (resulting from acquisitions) and the warranty business.

**Minority Interest Expense** Minority interest expense represents the interest of non-controlling investors in the earnings or losses of consolidated subsidiaries. Included in minority interest expense in the first nine months of 2004 is \$1.2 million for the interest of minority holders in the CDO entity which AFG consolidated prior to its liquidation in 2005.

**Cumulative Effect of Accounting Change** In January 2004, AFG recorded a \$1.8 million charge (after tax and minority interest) resulting from GAFRI's implementation of Statement of Position ("SOP") 03-1, "Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts." This charge resulted primarily from a change in accounting for persistency bonuses and two-tier annuities.

In July 2004, AFG recorded a \$3.8 million after-tax charge resulting from implementation of EITF 03-16, "Accounting for Investments in Limited Liability Companies." This charge reflects the cumulative effect of changing from the cost method to the equity method of accounting for AFG's investment in a limited liability company. This charge reduced AFG's investment in this entity to zero. Management believes the fair value of this investment substantially exceeds its carrying value prior to the writedown.

#### **Proposed Accounting Standard**

**Convertible Notes** The FASB has proposed an amendment to SFAS 128, "Earnings per Share." Currently, SFAS 128 allows companies issuing securities that can be settled in cash or stock (such as AFG's convertible notes) to exclude the issuable shares from the calculation of diluted earnings per share when there is a stated intent and ability to deliver cash in lieu of stock upon settlement or conversion. The proposed amendment would require companies to assume settlement in stock (despite the ability and intent to settle in cash) and include those shares in the calculation of diluted earnings per share. Should the FASB proposal be adopted as proposed, AFG anticipates that it will amend the convertible note indenture to eliminate the option to settle the accreted value of the notes in shares, and thereby mitigate the proposal's impact on dilution.

ITEM 3

**Quantitative and Qualitative Disclosure of Market Risk**

Other than as discussed in Management's Discussion and Analysis - "Annuity, Supplemental Insurance and Life Acquisition Expenses," with respect to a potential write-off of deferred acquisition costs in the fourth quarter of 2005, as of September 30, 2005, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure of Market Risk" of AFG's 2004 Form 10-K.

ITEM 4

**Controls and Procedures**

AFG's management, with participation of its Co-Chief Executive Officers and its principal financial officer, has evaluated AFG's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this report. Based on that evaluation, AFG's Co-CEOs and principal financial officer concluded that these disclosure controls and procedures were effective.

In the ordinary course of business, AFG and its subsidiaries routinely enhance their information systems by either upgrading current systems or implementing new systems. Examples include subsidiary implementation of a new general ledger system and payroll system during the first quarter of 2005. There has been no change in AFG's business processes and procedures during the third fiscal quarter of 2005 that has materially affected, or is reasonably likely to materially affect, AFG's internal controls over financial reporting.

## AMERICAN FINANCIAL GROUP, INC. 10-Q

### PART II OTHER INFORMATION

#### ITEM 1

##### Legal Proceedings

As previously reported under "Legal Proceedings" in AFG's 2004 Form 10-K, Great American Insurance Company entered into an agreement in 2003, which was approved by the bankruptcy court, for the settlement of coverage litigation related to A.P. Green asbestos claims. The settlement is for \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest). The agreement allows up to 10% of the settlement to be paid in AFG Common Stock. The settlement agreement is conditioned upon confirmation of a plan of reorganization that includes an injunction prohibiting the assertion against Great American of any present or future asbestos personal injury claims under policies issued to A.P. Green and related companies.

On September 15, 2005, A.P. Green filed its First Amended Plan of Reorganization. The plan is undergoing review for comment by interested parties. No assurance can be made that all conditions will be met; no payments are required until completion of the process. If the conditions are not met, the outcome of this litigation will again be subject to the complexities and uncertainties associated with a Chapter 11 proceeding and asbestos coverage litigation.

#### ITEM 6

##### Exhibits

<u>Number</u>	<u>Exhibit Description</u>
12	Computation of ratios of earnings to fixed charges.
31(a)	Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(b)	Certification of the Co-Chief Executive Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
31(c)	Certification of the Chief Financial Officer pursuant to section 302(a) of the Sarbanes-Oxley Act of 2002.
32	Certification of the Co-Chief Executive Officers and Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.



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

**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 4, 2005

BY: s/Keith A. Jensen  
Keith A. Jensen  
Senior Vice President  
(principal financial and  
accounting officer)

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

**EXHIBIT 12 - COMPUTATION OF RATIOS OF EARNINGS TO FIXED CHARGES  
(Dollars in Thousands)**

	Nine Months Ended <u>September 30, 2005</u>	Year Ended <u>December 31, 2004</u>
Pretax income excluding discontinued operations	\$200,007	\$552,245
Minority interest in subsidiaries having fixed charges	22,120	28,882
Less undistributed equity in losses of investee	7,544	4,883
Fixed charges:		
Interest on annuities	246,529	313,627
Interest expense	54,656	71,738
Interest on subsidiary trust obligations	4,848	9,218
Debt discount and expense	1,891	3,841
Portion of rentals representing interest	<u>8,813</u>	<u>11,751</u>
 EARNINGS	 <u>\$546,408</u>	 <u>\$996,185</u>
 Fixed charges:		
Interest on annuities	\$246,529	\$313,627
Interest expense	54,656	71,738
Interest on subsidiary trust obligations	4,848	9,218
Debt discount and expense	1,891	3,841
Portion of rentals representing interest	<u>8,813</u>	<u>11,751</u>
 FIXED CHARGES	 <u>\$316,737</u>	 <u>\$410,175</u>
 Ratio of Earnings to Fixed Charges	 <u>1.73</u>	 <u>2.43</u>
 Earnings in Excess of Fixed Charges	 <u>\$229,671</u>	 <u>\$586,010</u>

AMERICAN FINANCIAL GROUP, INC. 10-Q

EXHIBIT 31(a)

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

I, Carl H. Lindner III, certify that:

1. I have reviewed this quarterly report on Form 10-Q of American Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 4, 2005

BY: s/Carl H. Lindner III  
Carl H. Lindner III  
Co-Chief Executive Officer  
(principal executive officer)

AMERICAN FINANCIAL GROUP, INC. 10-Q

EXHIBIT 31(b)

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

I, S. Craig Lindner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of American Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 4, 2005

BY: s/S. Craig Lindner  
S. Craig Lindner  
Co-Chief Executive Officer  
(principal executive officer)

AMERICAN FINANCIAL GROUP, INC. 10-Q

EXHIBIT 31(c)

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS - CONTINUED

I, Keith A. Jensen, certify that:

1. I have reviewed this quarterly report on Form 10-Q of American Financial Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 4, 2005

BY: s/Keith A. Jensen  
Keith A. Jensen  
Senior Vice President  
(principal financial and  
accounting officer)

AMERICAN FINANCIAL GROUP, INC. 10-Q

EXHIBIT 32

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002

In connection with the filing with the Securities and Exchange Commission of the Quarterly Report of American Financial Group, Inc. (the "Company") on Form 10-Q for the period ended September 30, 2005 (the "Report"), the undersigned officers of the Company, certify, pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to the best of their knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

November 4, 2005  
Date

BY: s/S. Craig Lindner  
S. Craig Lindner  
Co-Chief Executive Officer

November 4, 2005  
Date

BY: s/Carl H. Lindner III  
Carl H. Lindner III  
Co-Chief Executive Officer

November 4, 2005  
Date

BY: s/Keith A. Jensen  
Keith A. Jensen  
Senior Vice President  
(principal financial and  
accounting officer)

**A signed original of this written statement will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.**