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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  
June 30, 2002**

**Commission File  
No. 1-7361**

**AMERICAN FINANCIAL CORPORATION**

**Incorporated under  
the Laws of Ohio**

**IRS Employer I.D.  
No. 31-0624874**

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

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

As of August 1, 2002, there were 10,593,000 shares of the Registrant's Common Stock outstanding, all of which were owned by American Financial Group, Inc.

**AMERICAN FINANCIAL CORPORATION 10-Q**  
**PART I**  
**FINANCIAL INFORMATION**

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEET**  
(Dollars In Thousands)

	<u>June 30,</u> 2002	<u>December 31,</u> 2001
<b>Assets:</b>		
Cash and short-term investments	\$ 444,299	\$ 543,644
Investments:		
Fixed maturities - at market (amortized cost - \$11,159,709 and \$10,593,205)	11,429,209	10,748,605
Other stocks - at market (cost - \$182,049 and \$187,810)	323,749	313,710
Policy loans	214,928	211,288
Real estate and other investments	255,922	262,801
Total investments	<u>12,223,808</u>	<u>11,536,404</u>
Recoverables from reinsurers and prepaid reinsurance premiums	2,545,203	2,286,509
Agents' balances and premiums receivable	774,730	666,171
Deferred acquisition costs	886,281	818,323
Other receivables	337,520	254,137
Variable annuity assets (separate accounts)	518,546	529,590
Prepaid expenses, deferred charges and other assets	465,966	451,362
Goodwill	312,594	312,134
	<u>\$18,508,947</u>	<u>\$17,398,274</u>
<b>Liabilities and Capital:</b>		
Unpaid losses and loss adjustment expenses	\$ 4,943,957	\$ 4,777,580
Unearned premiums	1,814,249	1,640,955
Annuity benefits accumulated	6,051,718	5,832,120
Life, accident and health reserves	912,087	638,522
Payable to American Financial Group, Inc.	328,011	356,689
Long-term debt:		
Holding companies	241,776	228,252
Subsidiaries	270,134	270,752
Variable annuity liabilities (separate accounts)	518,546	529,590
Accounts payable, accrued expenses and other liabilities	1,339,907	1,185,146
Total liabilities	<u>16,420,385</u>	<u>15,459,606</u>
Minority interest	476,397	460,737
Shareholders' Equity:		
Preferred Stock - at liquidation value	72,154	72,154
Common Stock, no par value		
- 20,000,000 shares authorized		
- 10,593,000 shares outstanding	9,625	9,625
Capital surplus	986,625	984,125
Retained earnings	314,761	255,127
Unrealized gain on marketable securities, net	229,000	156,900
Total shareholders' equity	<u>1,612,165</u>	<u>1,477,931</u>
	<u>\$18,508,947</u>	<u>\$17,398,274</u>

**AMERICAN FINANCIAL CORPORATION 10-Q**

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF EARNINGS  
(In Thousands)**

	Three months ended June 30,		Six months ended June 30,	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
<b>Income:</b>				
Property and casualty insurance premiums	\$618,935	\$679,563	\$1,222,843	\$1,324,286
Life, accident and health premiums	72,709	70,533	143,644	139,691
Investment income	213,518	214,374	434,477	424,164
Realized losses on:				
Securities	(47,490)	(26,425)	(65,290)	(33,306)
Subsidiaries	-	-	-	(1,586)
Other income	62,405	56,915	110,017	115,207
	<u>920,077</u>	<u>994,960</u>	<u>1,845,691</u>	<u>1,968,456</u>
<b>Costs and Expenses:</b>				
Property and casualty insurance:				
Losses and loss adjustment expenses	459,037	526,411	901,950	1,022,627
Commissions and other underwriting expenses	166,689	192,902	336,955	377,876
Annuity benefits	71,016	70,716	146,541	139,980
Life, accident and health benefits	59,392	52,211	115,312	106,294
Interest charges on borrowed money	11,554	14,777	22,648	33,650
Other operating and general expenses	121,600	114,505	234,911	222,376
	<u>889,288</u>	<u>971,522</u>	<u>1,758,317</u>	<u>1,902,803</u>
Operating earnings before income taxes	30,789	23,438	87,374	65,653
Provision for income taxes	5,685	4,347	8,388	19,299
Net operating earnings	25,104	19,091	78,986	46,354
Minority interest expense, net of tax	(6,311)	(4,188)	(11,379)	(11,107)
Equity in net losses of investees, net of tax	(2,353)	(2,313)	(5,087)	(5,647)
Earnings before cumulative effect of accounting change	16,440	12,590	62,520	29,600
Cumulative effect of accounting change	-	(10,040)	-	(10,040)
<b>Net Earnings</b>	<u>\$ 16,440</u>	<u>\$ 2,550</u>	<u>\$ 62,520</u>	<u>\$ 19,560</u>

**AMERICAN FINANCIAL CORPORATION 10-Q**

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
(Dollars in Thousands)**

	Preferred Stock	Common Stock and Capital Surplus	Retained Earnings	Unrealized Gain on Securities	Total
<b>Balance at January 1, 2002</b>	<u>\$72,154</u>	<u>\$993,750</u>	<u>\$255,127</u>	<u>\$156,900</u>	<u>\$1,477,931</u>
Net earnings	-	-	62,520	-	62,520
Change in unrealized Comprehensive income	-	-	-	72,100	<u>72,100</u>
					134,620
Capital contribution from parent	-	3,067	-	-	3,067
Dividends on Preferred Stock	-	-	(2,886)	-	(2,886)
Other	<u>-</u>	<u>(567)</u>	<u>-</u>	<u>-</u>	<u>(567)</u>
<b>Balance at June 30, 2002</b>	<u>\$72,154</u>	<u>\$996,250</u>	<u>\$314,761</u>	<u>\$229,000</u>	<u>\$1,612,165</u>
<b>Balance at January 1, 2001</b>	\$72,154	\$984,391	\$258,371	\$139,200	\$1,454,116
Net earnings	-	-	19,560	-	19,560
Change in unrealized Comprehensive income	-	-	-	25,740	<u>25,740</u>
					45,300
Capital contribution from parent	-	6,134	-	-	6,134
Dividends on Preferred Stock	-	-	(2,886)	-	(2,886)
Other	<u>-</u>	<u>(9)</u>	<u>-</u>	<u>-</u>	<u>(9)</u>
<b>Balance at June 30, 2001</b>	<u>\$72,154</u>	<u>\$990,516</u>	<u>\$275,045</u>	<u>\$164,940</u>	<u>\$1,502,655</u>

**AMERICAN FINANCIAL CORPORATION 10-Q**

**AMERICAN FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(In Thousands)**

	Six months ended June 30,	
	<u>2002</u>	<u>2001</u>
<b>Operating Activities:</b>		
Net earnings	\$ 62,520	\$ 19,560
Adjustments:		
Cumulative effect of accounting change	-	10,040
Equity in net losses of investees	5,087	5,647
Depreciation and amortization	92,899	71,503
Annuity benefits	146,541	139,980
Realized losses on investing activities	57,539	10,167
Deferred annuity and life policy acquisition costs	(80,775)	(73,530)
Increase in reinsurance and other receivables	(355,340)	(77,612)
Increase in other assets	(41,250)	(26,742)
Increase in insurance claims and reserves	375,850	169,679
Increase in other liabilities	99,369	74,352
Increase in minority interest	7,160	4,770
Other, net	(1,651)	1,521
	<u>367,949</u>	<u>329,335</u>
<b>Investing Activities:</b>		
Purchases of and additional investments in:		
Fixed maturity investments	(2,484,455)	(981,049)
Equity securities	(10,562)	(2,907)
Subsidiary	(48,500)	-
Real estate, property and equipment	(29,689)	(31,090)
Maturities and redemptions of fixed maturity investments	827,153	337,280
Sales of:		
Fixed maturity investments	1,168,341	368,003
Equity securities	18,109	9,148
Subsidiaries	-	22,000
Real estate, property and equipment	10,559	43,456
Cash and short-term investments of acquired (former) subsidiaries, net	4,642	(132,858)
Decrease (increase) in other investments	12,989	(171)
	<u>(531,413)</u>	<u>(368,188)</u>
<b>Financing Activities:</b>		
Fixed annuity receipts	361,223	271,827
Annuity surrenders, benefits and withdrawals	(278,496)	(341,310)
Net transfers to variable annuity assets	(2,855)	(1,368)
Additional long-term borrowings	59,000	78,868
Reductions of long-term debt	(46,434)	(83,192)
Borrowings from AFG	7,400	7,600
Payments to AFG	(37,500)	(53,500)
Capital contribution	4,667	9,334
Cash dividends paid	(2,886)	(2,886)
	<u>64,119</u>	<u>(114,627)</u>
<b>Net Decrease in Cash and Short-term Investments</b>	(99,345)	(153,480)
Cash and short-term investments at beginning of period	<u>543,644</u>	<u>437,263</u>
Cash and short-term investments at end of period	<u>\$ 444,299</u>	<u>\$283,783</u>

## AMERICAN FINANCIAL CORPORATION 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### A. Accounting Policies

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

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

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

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

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

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

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

## AMERICAN FINANCIAL CORPORATION 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

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

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

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

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

DPAC related to traditional life and health insurance is amortized over the expected premium paying period of the related policies, in proportion to the ratio of annual premium revenues to total anticipated premium revenues.

**Unpaid Losses and Loss Adjustment Expenses** The net liabilities stated for unpaid claims and for expenses of investigation and adjustment of unpaid claims are based upon (a) the accumulation of case estimates for losses reported prior to the close of the accounting period on direct business written; (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of unreported losses based on past experience; (d) estimates based on experience of expenses for investigating and adjusting claims and (e) the current state of the law and coverage litigation. 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 Earnings in the period in which determined. In spite of the variability inherent in such estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

## AMERICAN FINANCIAL CORPORATION 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED

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

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

**Variable Annuity Assets and Liabilities** Separate accounts related to variable annuities represent deposits invested in underlying investment funds on which Great American Financial Resources, Inc. ("GAFRI"), an 83%-owned subsidiary, earns a fee. Investment funds are selected and may be changed only by the policyholder, who retains all investment risk. Accordingly, GAFRI's liability for these accounts equals the value of the account assets.

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

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

**Minority Interest** For balance sheet purposes, minority interest represents (i) the interests of noncontrolling shareholders in AFC subsidiaries, including preferred securities issued by trust subsidiaries of GAFRI and (ii) American Financial Group, Inc.'s ("AFG") direct ownership interest in American Premier Underwriters, Inc. ("American Premier" or "APU") and American Financial Enterprises, Inc. For income statement purposes, minority interest expense represents those shareholders' interest in the earnings of AFC subsidiaries as well as accrued distributions on the trust preferred securities.

**Income Taxes** AFC files consolidated federal income tax returns which include all 80%-owned U.S. subsidiaries, except for certain life insurance subsidiaries and their subsidiaries. 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.



## AMERICAN FINANCIAL CORPORATION 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED

**Benefit Plans** AFC provides retirement benefits to qualified employees of participating companies through contributory and noncontributory defined contribution plans contained in AFG's Retirement and Savings Plan. The Company makes all contributions to the retirement fund and matches a portion of employee contributions to the savings fund. Employees have been permitted to direct the investment of their contributions to independently managed investment funds, while Company contributions have been invested primarily in securities of AFG and affiliates. Employees are being afforded the flexibility to direct the investment of a portion of their vested retirement fund account balances (increasing from 12.5% in July 2002 to 100% in April 2004) from securities of AFG and its affiliates to independently managed investment funds. The Plan owns 12% of AFG's outstanding Common Stock. Company contributions are charged against earnings in the year for which they are declared.

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

**Derivatives** Derivatives included in AFC's Balance Sheet consist primarily of investments in common stock warrants (included in other stocks), the equity-based component of certain annuity products (included in annuity benefits accumulated) and call options (included in other investments) used to mitigate the risk embedded in the equity-indexed annuity products. Changes in the fair value of derivatives are included in current earnings.

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

#### **B. Acquisitions and Sales of Subsidiaries**

**Manhattan National Life Insurance** On June 28, 2002, GAFRI acquired Manhattan National Life Insurance Company ("MNL") from Consec, Inc. for \$48.5 million in cash. While MNL is not currently writing new policies, the company reported over \$43 million of statutory renewal premiums in 2001. At December 31, 2001, MNL had approximately 90,000 policies in force (primarily term life) representing over \$12 billion in face amount of insurance, statutory assets of \$297.8 million and statutory capital and surplus of \$23.1 million.

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

**AMERICAN FINANCIAL CORPORATION 10-Q**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED**

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

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

	Three months ended		Six months ended	
	June 30,		June 30,	
<b>Revenues (a)</b>	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Property and casualty insurance:				
Premiums earned:				
Specialty	\$370,286	\$356,188	\$ 726,701	\$ 672,495
Personal	248,617	322,629	495,820	650,261
Other lines (b)	32	746	322	1,530
	<u>618,935</u>	<u>679,563</u>	<u>1,222,843</u>	<u>1,324,286</u>
Investment and other income	75,678	106,440	175,937	213,775
	<u>694,613</u>	<u>786,003</u>	<u>1,398,780</u>	<u>1,538,061</u>
Annuities, life and health (c)	207,620	202,562	425,042	419,592
Other	17,844	6,395	21,869	10,803
	<u>\$920,077</u>	<u>\$994,960</u>	<u>\$1,845,691</u>	<u>\$1,968,456</u>
<b>Operating Profit (Loss)</b>				
Property and casualty insurance:				
Underwriting:				
Specialty	\$ 7,377	(\$ 4,609)	\$ 12,671	(\$ 6,839)
Personal	(2,654)	(35,795)	(7,893)	(63,577)
Other lines (b)	(11,514)	654	(20,840)	(5,801)
	<u>(6,791)</u>	<u>(39,750)</u>	<u>(16,062)</u>	<u>(76,217)</u>
Investment and other income	32,923	69,147	96,174	144,349
	<u>26,132</u>	<u>29,397</u>	<u>80,112</u>	<u>68,132</u>
Annuities, life and health	11,108	17,335	33,089	47,458
Other (d)	(6,451)	(23,294)	(25,827)	(49,937)
	<u>\$ 30,789</u>	<u>\$ 23,438</u>	<u>\$ 87,374</u>	<u>\$ 65,653</u>

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

**AMERICAN FINANCIAL CORPORATION 10-Q**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**D. Goodwill** Effective January 1, 2002, goodwill is no longer amortized but is subject to annual impairment testing under a two step process. Under the first step, an entity's net assets are broken down into reporting units and compared to their fair value. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. AFC has completed the first step of its transitional impairment test and has identified potential impairment of goodwill in its annuities and life insurance segment and the personal lines segment of its property and casualty insurance business. The second step of the impairment test, that will measure the amount of impairment loss, will be completed by the end of the year with any resulting impairment charge reported by restating first quarter 2002 results for the cumulative effect of a change in accounting principle. Management believes that while an impairment charge may be as much as 15% of the carrying value of goodwill at June 30, 2002, it may be as little as half of that amount.

If the goodwill amortization of \$3.4 million in the second quarter and \$6.9 million in the first six months of 2001 had not been expensed, net earnings for the periods would have been \$6.0 million and \$26.5 million, respectively.

**E. Payable to American Financial Group** AFC has a reciprocal Master Credit Agreement with various AFG holding companies under which these companies make funds available to each other for general corporate purposes.

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

	June 30, <u>2002</u>	December 31, <u>2001</u>
<b>Holding Companies:</b>		
AFC notes payable under bank line	\$218,000	\$203,000
APU 10-7/8% Subordinated Notes due May 2011	11,527	11,557
Other	<u>12,249</u>	<u>13,695</u>
	<u>\$241,776</u>	<u>\$228,252</u>
<b>Subsidiaries:</b>		
GAFRI 6-7/8% Senior Notes due June 2008	\$100,000	\$100,000
GAFRI notes payable under bank line	121,100	121,100
Notes payable secured by real estate	35,936	36,253
Other	<u>13,098</u>	<u>13,399</u>
	<u>\$270,134</u>	<u>\$270,752</u>

At June 30, 2002, scheduled principal payments on debt for the balance of 2002 and the subsequent five years were as follows (in millions):

	Holding <u>Companies</u>	<u>Subsidiaries</u>	<u>Total</u>
2002	\$227.2	\$ .6	\$227.8
2003	-	1.2	1.2
2004	-	122.4	122.4
2005	-	10.4	10.4
2006	-	19.1	19.1
2007	79.7	.6	80.3

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

**AMERICAN FINANCIAL CORPORATION 10-Q**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED**

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

	June 30, <u>2002</u>	December 31, <u>2001</u>
Interest of AFG (parent) and noncontrolling shareholders in subsidiaries' common stock	\$333,484	\$317,824
Preferred securities issued by subsidiary trusts	<u>142,913</u>	<u>142,913</u>
	<u>\$476,397</u>	<u>\$460,737</u>

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

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

Date of Issuance	Issue (Maturity Date)	June 30, 2002	December 31, 2001	Optional Redemption Dates
November 1996	GAFRI 9-1/4% TOPrS (2026)	\$72,913	\$72,913	Currently redeemable
March 1997	GAFRI 8-7/8% Pfd (2027)	70,000	70,000	On or after 3/1/2007

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

	Six months ended June 30,	
	<u>2002</u>	<u>2001</u>
Interest of AFG (parent) and noncontrolling shareholders in earnings of subsidiaries	\$ 9,684	\$ 5,128
Effect of basis difference in realized gains (losses) of subsidiaries	(2,517)	-
Accrued distributions by subsidiaries on trust issued securities, net of tax	<u>4,212</u>	<u>5,979</u>
	<u>\$11,379</u>	<u>\$11,107</u>

- H. Shareholders' Equity** At June 30, 2002, and December 31, 2001, American Financial Group beneficially owned all of the outstanding shares of AFC's Common Stock.

**Preferred Stock** Under provisions of both the Nonvoting (4.0 million shares authorized) and Voting (4.0 million shares authorized) Cumulative Preferred Stock, the Board of Directors may divide the authorized stock into series and set specific terms and conditions of each series. At June 30, 2002, and December 31, 2001, the outstanding voting shares of AFC's Preferred Stock consisted of the following:

**Series J**, no par value; \$25.00 liquidating value per share; annual dividends per share \$2.00; redeemable at AFC's option at \$25.75 per share beginning December 2005 declining to \$25.00 at December 2007 and thereafter; 2,886,161 shares (stated value \$72.2 million) outstanding at June 30, 2002, and December 31, 2001.

**AMERICAN FINANCIAL CORPORATION 10-Q**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED**

The change in unrealized gain on marketable securities for the six months ended June 30 included the following (in millions):

	<u>Pretax</u>	<u>Taxes</u>	<u>Minority Interest</u>	<u>Net</u>
<u>2002</u>				
Unrealized holding gains on securities arising during the period	\$ 57.9	(\$19.9)	(\$2.0)	\$36.0
Realized losses included in net income	<u>65.3</u>	<u>(22.7)</u>	<u>(6.5)</u>	<u>36.1</u>
Change in unrealized gain on marketable securities, net	<u>\$123.2</u>	<u>(\$42.6)</u>	<u>(\$8.5)</u>	<u>\$72.1</u>
<u>2001</u>				
Unrealized holding losses on securities arising during the period	(\$ 3.4)	\$ 1.0	(\$0.8)	(\$ 3.2)
Adoption of EITF 99-20	16.9	(6.0)	(0.9)	10.0
Realized losses included in net income	<u>33.3</u>	<u>(11.7)</u>	<u>(2.7)</u>	<u>18.9</u>
Change in unrealized gain on marketable securities, net	<u>\$ 46.8</u>	<u>(\$16.7)</u>	<u>(\$4.4)</u>	<u>\$25.7</u>

- I. Equity in Losses of Investees** Since 1998, AFC subsidiaries have made loans to two start-up manufacturing businesses which were previously owned by unrelated third-parties. During 2000, the former owners chose to forfeit their equity interests to AFC rather than invest additional capital.

During the fourth quarter of 2000, AFC sold the equity interests to a group of employees for nominal cash consideration plus warrants to repurchase a significant ownership interest. Due to the absence of significant financial investment by the buyers relative to the amount of loans (\$61.5 million at December 31, 2000) owed to AFC subsidiaries, the sale was not recognized as a divestiture for accounting purposes. Assets of the businesses transferred (\$56.4 million at June 30, 2002 and \$57.1 million at December 31, 2001) are included in other assets; liabilities of the businesses transferred (\$10.6 million at June 30, 2002 and \$11.8 million at December 31, 2001, after consolidation and elimination of loans from AFC subsidiaries) are included in other liabilities. Investee losses in the Statement of Earnings represents AFC's equity in the losses of these two companies. One of the businesses is involved in litigation impacting its operations; see "Investee Corporations" in Management's Discussion and Analysis.

- J. Commitments and Contingencies** Aside from matters disclosed in Item 1 of Part II to this report, there have been no significant changes to the matters discussed and referred to in Note M "Commitments and Contingencies" of AFC's Annual Report on Form 10-K for 2001.

ITEM 2

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

**GENERAL**

AFC and American Premier are organized as holding companies with almost all of their operations being conducted by subsidiaries. These parent corporations, however, have continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends, and taxes. Therefore, certain analyses are best done on a parent only basis while others are best done on a total enterprise basis. In addition, since most of its businesses are financial in nature, AFC does not prepare its consolidated financial statements using a current-noncurrent format. Consequently, certain traditional ratios and financial analysis tests are not meaningful.

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

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

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

- changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;
- regulatory actions;
- changes in legal environment;
- tax law changes;
- levels of natural catastrophes, terrorist events, incidents of war and other major losses;
- the ultimate amount of liabilities associated with certain asbestos and environmental-related insurance claims;
- adequacy of loss reserves;
- availability of reinsurance and ability of reinsurers to pay their obligations; and
- competitive pressures, including the ability to obtain rate increases.

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

## AMERICAN FINANCIAL CORPORATION 10-Q

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

#### **LIQUIDITY AND CAPITAL RESOURCES**

**Ratios** AFC's debt to total capital ratio at the parent holding company level (excluding amounts due AFG) was approximately 13% at June 30, 2002, and December 31, 2001. Including amounts due AFG, the ratio was 26% at June 30, 2002, and 28% at December 31, 2001.

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

AFC has a revolving credit agreement with several banks under which it can borrow up to \$300 million until December 31, 2002. At June 30, 2002, just under three-fourths of the credit line had been used. While management expects to negotiate a replacement bank agreement later this year, market conditions indicate the maximum amount may be smaller and interest costs will likely be greater.

**Investments** AFC's investment portfolio at June 30, 2002, contained \$11.4 billion in "Fixed maturities" and \$323.7 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 June 30, 2002, AFC had pretax net unrealized gains of \$269.5 million on fixed maturities and \$141.7 million on other stocks.

Approximately 93% of the fixed maturities held by AFC at June 30, 2002, were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated and noninvestment grade. Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

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

**AMERICAN FINANCIAL CORPORATION 10-Q**

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

Summarized information for the unrealized gains and losses recorded in AFC's balance sheet at June 30, 2002, is shown in the following table (dollars in millions). Approximately \$517 million of "Fixed maturities" and \$46 million of "Other stocks" had no unrealized gains or losses at June 30, 2002.

	Securities with Unrealized Gains	Securities with Unrealized Losses
<u>Fixed Maturities</u>		
Market value of securities	\$9,052	\$1,860
Amortized cost of securities	\$8,674	\$1,968
Gross unrealized gain or loss	\$ 378	\$ 108
Market value as a % of amortized cost	104%	95%
Number of security positions	1,533	312
Number individually exceeding \$2 million gain or loss	4	12
Concentration of gains or losses by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$128.6	\$ 8.6
Banks	34.5	-
State and municipal	25.6	4.8
U.S. government	23.4	.9
Asset-backed securities	14.2	13.9
Air transportation	4.7	8.9
Telephone communications	3.9	19.4
Cable television	.2	7.9
Percentage rated investment grade	97%	78%
<u>Other Stocks</u>		
Market value of securities	\$ 257	\$ 21
Cost of securities	\$ 105	\$ 31
Gross unrealized gain or loss	\$ 152	\$ 10
Market value as a % of cost	245%	68%
Number individually exceeding \$2 million gain or loss	2	1

AFC's investment in equity securities of Provident Financial Group, a Cincinnati-based commercial banking and financial services company, represents \$138 million of the \$152 million in unrealized gains on other stocks at June 30, 2002.

The table below sets forth the scheduled maturities of fixed maturity securities at June 30, 2002, based on their market values.

<u>Maturity</u>	Securities with Unrealized Gains	Securities with Unrealized Losses
One year or less	6%	1%
After one year through five years	19	25
After five years through ten years	24	38
After ten years	<u>15</u>	<u>15</u>
	64	79
Mortgage-backed securities	<u>36</u>	<u>21</u>
	<u>100%</u>	<u>100%</u>



**AMERICAN FINANCIAL CORPORATION 10-Q**

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

AFC realized aggregate losses of \$11 million during the second quarter of 2002 on \$209.9 million in sales of fixed maturity securities (28 issues; 23 issuers) that had unrealized losses at March 31, 2002. Market values of 22 of the issues increased an aggregate of \$4 million from March 31 to date of sale. One of the securities was a Worldcom bond that decreased in value by \$3.3 million from March 31 to the date of sale due to the decline in Worldcom's financial condition. Market values of the remaining five securities decreased an aggregate of \$1.2 million from March 31 to the sale date. Six of the 28 issues had unrealized losses greater than \$500,000 at March 31. Excluding Worldcom, actual losses on sale were \$1.3 million less than the unrealized loss at March 31. Although AFC had the ability to continue holding these investments, its intent to hold them changed due primarily to deterioration in the issuer's credit, decisions to lessen exposure to a particular credit or industry, or to modify asset allocation within the portfolio.

The table below (dollars in millions) summarizes the length of time securities have been in an unrealized gain or loss position at June 30, 2002.

	Aggregate Market Value	Aggregate Unrealized Gain (Loss)	Market Value as % of Cost Basis
<u>Fixed Maturities</u>			
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 at 6/30/02 and for:			
Less than one year (172 issues)	\$2,192	\$133	106.5%
More than one year (51 issues)	688	60	109.6
Less than \$500,000 at 6/30/02 (1,310 issues)	<u>6,172</u>	<u>185</u>	103.1
	<u>\$9,052</u>	<u>\$378</u>	104.4
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 at 6/30/02 and for:			
Less than one year (37 issues)	\$ 307	(\$ 47)	86.7%
More than one year (14 issues)	100	(31)	76.3
Less than \$500,000 at 6/30/02 (261 issues)	<u>1,453</u>	<u>(30)</u>	98.0
	<u>\$1,860</u>	<u>(\$108)</u>	94.5
<u>Other Stocks</u>			
<b>Securities with unrealized gains:</b>			
Exceeding \$500,000 at 6/30/02 and for:			
Less than one year (2 issues)	\$ 10	\$ 2	125.0%
More than one year (3 issues)	233	147	270.9
Less than \$500,000 at 6/30/02 (57 issues)	<u>14</u>	<u>3</u>	127.3
	<u>\$ 257</u>	<u>\$152</u>	244.8
<b>Securities with unrealized losses:</b>			
Exceeding \$500,000 at 6/30/02 and for:			
Less than one year (3 issues)	\$ 4	(\$ 6)	40.0%
More than one year (0 issues)	-	-	-
Less than \$500,000 at 6/30/02 (71 issues)	<u>17</u>	<u>(4)</u>	81.0
	<u>\$ 21</u>	<u>(\$ 10)</u>	67.7

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 AFC's 2001 Form 10-K.

## AMERICAN FINANCIAL CORPORATION 10-Q

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

Based on its analysis, management believes (i) AFC will recover its cost basis in the securities with unrealized losses and (ii) that AFC 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 AFC's liquidity.

**Uncertainties** As more fully explained in the following paragraphs, 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.

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

**Asbestos and Environmental-related ("A&E") Reserves** Establishing reserves for A&E claims is subject to uncertainties that are significantly greater than those presented by other types of claims. Estimating ultimate liability for asbestos claims presents unique and difficult challenges to the insurance industry due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage. The casualty insurance industry is engaged, as is AFC, in extensive litigation over these coverage and liability issues as the volume and severity of claims against asbestos defendants continue to increase.

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

Further, certain policyholders assert that each bodily injury claim should be treated as a separate occurrence under the policy, and that their claims are not subject to aggregate limits on coverage because either their policies did not contain aggregate limits with respect to products liability coverage or, faced with exhaustion of products coverage limits, their asbestos claims fall within non-products liability coverage which is not subject to any aggregate limit. These claims are now being contested in insurance coverage litigation in various jurisdictions. In rejecting the claims that are the basis of this litigation, AFC believes its coverage defenses are substantial and intends to continue to vigorously defend its position. Nonetheless, the outcome of disputes related to asbestos and environmental matters, whether through litigation or negotiation, may result in liabilities exceeding current related reserves by amounts that

## AMERICAN FINANCIAL CORPORATION 10-Q

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

could have a material adverse effect upon AFC's results of operations and financial condition.

For further discussion of uncertainties and litigation involving AFC, see "Legal Proceedings."

#### **RESULTS OF OPERATIONS**

**General** Pretax operating earnings for the second quarter and six months of 2002 were \$30.8 million and \$87.4 million compared to \$23.4 million and \$65.7 million for the comparable 2001 periods. Results reflect significantly improved property and casualty underwriting results, partially offset by a decrease in income from the sale of real estate and higher realized losses.

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

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

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

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

**AMERICAN FINANCIAL CORPORATION 10-Q**

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

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

	Three months ended June 30,		Six months ended June 30,	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
<u>Gross Written Premiums (GAAP)</u>				
Specialty	\$662.1	\$544.1	\$1,241.0	\$1,030.0
Personal	335.9	312.9	689.5	692.9
Other lines	-	.1	.3	.1
	<u>\$998.0</u>	<u>\$857.1</u>	<u>\$1,930.8</u>	<u>\$1,723.0</u>
<u>Net Written Premiums (GAAP)</u>				
Specialty	\$393.8	\$393.8	\$ 780.5	\$ 750.4
Personal	244.9	252.0	501.3 (a)	622.5
Other lines	-	-	.3	-
	<u>\$638.7</u>	<u>\$645.8</u>	<u>\$1,282.1</u>	<u>\$1,372.9</u>
<u>Combined Ratios (GAAP)</u>				
Specialty	98.0%	101.3%	98.3%	101.0%
Personal	101.1	111.1	101.6	109.8
Aggregate (including discontinued lines)	101.1	105.9	101.4	105.7

(a) Reflects the ceding of \$171 million in premiums in 2002 compared to \$50 million in 2001 under a reinsurance agreement (effective April 1, 2001).

**Specialty** The Specialty group's gross written premiums for the second quarter and six months of 2002 increased more than 20% over the comparable 2001 periods. These increases reflect the impact of rate increases and the realization of growth opportunities in certain commercial markets, partially offset by the decision to discontinue certain lines of business (during 2001) that were not achieving adequate returns. Specialty rate increases averaged approximately 30% during the first six months of 2002 and are expected to average about 30% for the year. Net written premiums were comparable to 2001 for the second quarter and increased by 4% for the six months. Strong growth in gross written premiums was offset by increased reinsurance coverage in certain lines.

The Specialty group reported a solid underwriting profit for the six months and second quarter of 2002 with a combined ratio of 98.0% for the quarter and 98.3% for the six months. The improvement in the combined ratios compared to 2001 reflects strategic changes in the mix of specialty businesses and the impact of rate increases.

**Personal** The Personal group's gross written premiums for the second quarter increased 7% compared to the second quarter of 2001 as the impact of rate increases was partially offset by lower business volume. Effective April 1, 2001, AFC began reinsuring 80% of the automobile physical damage business written by three of its insurance subsidiaries. In July 2001, the agreement was amended to increase the level of reinsurance to 90% and to add an additional insurance subsidiary. This agreement enables AFC to reallocate some of its capital to the more profitable specialty operations. The decline in net written premiums for the second quarter and six months reflects the impact of this reinsurance agreement. Rate increases implemented in the first six months of 2002 were about 8% and are expected to be about 10% for the year.

## AMERICAN FINANCIAL CORPORATION 10-Q

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

As a result of rate increases implemented over the last year, the Personal group's combined ratio improved by 10 points for the second quarter and 8.2 points for the six months compared to the 2001 periods. Nearly 90% of the Personal group's business is written through independent agents. Business written through this distribution channel achieved an underwriting profit for the third consecutive quarter with a combined ratio of 98.2% for second quarter of 2002. Management expects the Personal group as a whole to achieve underwriting profitability by the fourth quarter of 2002.

**Real Estate Operations** AFC'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 AFC's Statement of Earnings as shown below (in millions).

	Three months ended		Six months ended	
	June 30,		June 30,	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Other income	\$29.6	\$29.4	\$44.9	\$61.4
Other operating and general expenses	17.7	16.6	32.2	31.6
Interest charges on borrowed money	.7	.6	1.3	1.3
Minority interest expense, net	.5	1.4	.5	3.3

Other income includes net pretax gains on the sale of real estate assets of \$7.5 million in the second quarter and \$7.6 million in the first six months of 2002 compared to \$9.3 million and \$24.6 million for the 2001 periods.

**Other Income** Excluding gains on sales of real estate assets (discussed above), other income increased \$7.3 million (15%) for the second quarter and \$11.8 million (13%) for the first six months of 2002 compared to 2001 due primarily to fees earned by the Specialty group's new warranty business and higher fee income in certain other specialty insurance operations.

**Realized Gains** Realized capital gains have been an important part of the return on investments. Individual assets are sold creating gains and losses as market opportunities exist.

**Losses on Securities** Realized losses on securities include provisions for other than temporary impairment of securities still held as follows: second quarter of 2002 and 2001 - \$70.1 million and \$29.2 million; six months of 2002 and 2001 - \$88.4 million and \$37.2 million, respectively. Increased impairment charges in recent years reflect a rise in corporate defaults in the marketplace.

Warrants to purchase common stock of publicly traded companies are generally considered derivatives and marked to market through current earnings as realized gains and losses. Realized losses on securities include gains of \$3.7 million in the second quarter of 2002 and \$660,000 for the first six months of 2002 compared to gains of \$3.2 million and \$2.3 million in the 2001 periods to adjust the carrying value of AFC's investment in warrants to market value (\$26.4 million at June 30, 2002).

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

**Annuity Benefits** Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. The majority of GAFRI's fixed rate annuity

## AMERICAN FINANCIAL CORPORATION 10-Q

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

products permit GAFRI to change the crediting rate at any time (subject to minimum interest rate guarantees of 3% or 4% per annum). As a result, management has been able to react to changes in market interest rates and maintain a desired interest rate spread.

**Interest Expense** Interest expense for the second quarter and first six months of 2002 decreased compared to 2001 as lower average interest rates on AFC's variable rate debt (including AFC's payable to AFG) more than offset higher average indebtedness.

**Other Operating and General Expenses** Other operating and general expenses for the second quarter and first six months of 2001 include goodwill amortization of \$3.4 million and \$6.9 million, respectively. Under SFAS No. 142, which was implemented January 1, 2002, goodwill is no longer amortized. Excluding 2001 goodwill amortization, other operating and general expenses increased \$10.5 million (9%) for the second quarter and \$19.4 million (9%) for the first six months compared to 2001. Expenses of the Specialty group's new warranty business, higher expenses related to growth in certain other Specialty operations and increased amortization of annuity and life deferred policy acquisition costs were partially offset by lower IT-related expenses.

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

**Investee Corporations** Equity in losses of investee corporations represents losses of two start-up manufacturing businesses (see Note G). In November 2001, an injunction was issued against one of the companies which would prohibit the company from using equipment subject to litigation alleging the misappropriation of a trade secret and effectively close the plant. The injunction was subsequently modified, pending appeal, to permit operations to continue and require certain escrow payments. If the investee is unsuccessful in its attempt to have the injunction lifted or further modified, or if operating results fail to improve, a substantial portion of AFC's investment (\$32.3 million as of June 30, 2002), may be written off.

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

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### ITEM 3

#### **Quantitative and Qualitative Disclosure of Market Risk**

As of June 30, 2002, there were no material changes to the information provided in AFC's Form 10-K for 2001 under the caption "Exposure to Market Risk" in Management's Discussion and Analysis of Financial Condition and Results of Operations.

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### PART II OTHER INFORMATION

#### ITEM 1

##### Legal Proceedings

AFC's subsidiaries are parties to litigation and receive claims asserting alleged injuries and damages from asbestos, environmental and other substances and workplace hazards and have established loss accruals for such potential liabilities.

As previously reported, A.P. Green Industries, Inc. and its subsidiary, A.P. Green Services, Inc. (the "Policyholders") filed petitions for bankruptcy under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of Pennsylvania (In re: Global Industrial Technologies, Inc., et al., filed February 14, 2002). Great American Insurance Company and certain other insurers are parties to litigation with the Policyholders involving liability coverage for a substantial number of asbestos related bodily injury claims that have been asserted against the Policyholders. These claims (some of which are direct actions against Great American) allege that the refractory materials manufactured, sold or installed by the Policyholders contained asbestos and resulted in bodily injury from exposure to asbestos. The Policyholders seek to recover defense and indemnity expenses related to those claims from a number of insurers, including Great American, and in an effort to maximize coverage assert that Great American's policies on various grounds are not subject to aggregate limits on liability, that each exposure alleged by a claimant constitutes a separate occurrence, and that each insurer is liable for all sums the Policyholders become legally obliged to pay. Prior to the bankruptcy filing, Great American sought to have these coverage issues decided as part of a contribution and declaratory judgment action that it brought several years earlier (Great American Insurance Company, et al. v. The Royal Insurance Company, et al., United States District Court, Southern District of Ohio, filed January 29, 1998) (the "District Court Action") and asked the court to declare, among other things, that all asbestos bodily injury claims against the Policyholders constitute not more than one occurrence and are subject to a \$1,000,000 aggregate limit under each of the four Great American policies at issue in the action and should be allocated among triggered policies and implicated years on a pro rata basis. Great American believes that its coverage defenses are substantial and intends to vigorously defend its position if it is unable to arrive at a mutually acceptable resolution of the claims. The bankruptcy filing, however, stays the District Court Action. In March 2002, Great American and certain other insurers filed a motion in the Bankruptcy Court to modify the stay so as to permit the District Court action to proceed. During the same month, the Policyholders filed adversary proceedings in the Bankruptcy Court to decide the coverage issues.

On June 4, 2002, the Bankruptcy Court entered orders continuing proceedings on both the stay motion and the adversary proceeding and referring the insurance coverage dispute to non-binding mediation. If the mediation does not result in a negotiated settlement, and if the stay is not modified or the adversary proceedings are permitted to go forward in the Bankruptcy Court, then the resolution of these disputes will be subject to the complexities and uncertainties associated with a Chapter 11 proceeding.

For a further discussion of the uncertainties relative to confronting asbestos and environmental claims, see the following sections of AFC's 2001 Form 10-K: *Business - "Asbestos and Environmental Reserves"* and *Note M - "Commitments And Contingencies"* to the Financial Statements. As a consequence of these uncertainties, the outcome of disputes related to asbestos and environmental

## AMERICAN FINANCIAL CORPORATION 10-Q

### PART II OTHER INFORMATION - CONTINUED

matters, whether through litigation or negotiation, may result in liabilities exceeding current related reserves by an amount that could have a material adverse effect on AFC's results of operations and financial condition.

In March 2000, a jury in Dallas, Texas, returned a verdict against Great American Life Insurance Company ("GALIC") with total damages of \$11.2 million in a lawsuit brought by two former agents of GALIC (Martin v. Great American Life Insurance Company, 191<sup>st</sup> District Court of Dallas County, Texas, Case No. 96-04843). The former agents had alleged that their agency agreement with GALIC had been wrongfully terminated. On August 6, 2002, the Texas Fifth District Court of Appeals issued an opinion reversing the verdict in its entirety and finding that GALIC had no liability to the plaintiffs based on the facts of the case. The plaintiffs have no further appeal rights in this case.

#### ITEM 6

##### Exhibits and Reports on Form 8-K

- (a) Exhibit 99 - Certification pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
- (b) Reports on Form 8-K: none



**AMERICAN FINANCIAL CORPORATION 10-Q**

**Signature**

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

American Financial Corporation

August 13, 2002

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

AMERICAN FINANCIAL CORPORATION 10-Q

EXHIBIT 99

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER

Pursuant to 18 U.S.C. section 1350, as adopted 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 Corporation (the "Company") on Form 10-Q for the period ended June 30, 2002 (the "Report"), the undersigned officers of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted 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.

August 13, 2002  
Date

BY: Carl H. Lindner  
Carl H. Lindner  
Chairman of the Board and  
Chief Executive Officer

August 13, 2002  
Date

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