AMERICAN FINANCIAL GROUP INC
Form 10-Q
May 09, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of

the Securities Exchange Act of 1934

For the Quarterly Period Ended March 31, 2012

Commission File No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under	**IRS Employer**
the Laws of Ohio	**I.D. No. 31-1544320**

301 East Fourth Street, Cincinnati, Ohio 45202

(513) 579-2121

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company:

Large Accelerated Filer	x	Accelerated Filer	¨
Non-Accelerated Filer	¨	Smaller Reporting Company	¨

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

As of May 1, 2012, there were 96,887,372 shares of the Registrant s Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

Table of Contents

AMERICAN FINANCIAL GROUP, INC.

TABLE OF CONTENTS

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

PART I

ITEM I FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (UNAUDITED)

(Dollars In Millions)

	March 31, 2012	December 31, 2011 (as adjusted)
Assets:		
Cash and cash equivalents	$ 1,422	$ 1,324
Investments:		
Fixed maturities, available for sale at fair value (amortized cost $20,994 and $20,562)	22,371	21,807
Fixed maturities, trading at fair value	457	440
Equity securities, at fair value (cost $800 and $744)	1,054	928
Mortgage loans	438	401
Policy loans	249	252
Real estate and other investments	487	425
Total cash and investments	26,478	25,577
Recoverables from reinsurers	2,678	2,942
Prepaid reinsurance premiums	415	409
Agents balances and premiums receivable	550	565
Deferred policy acquisition costs	916	901
Assets of managed investment entities	2,952	3,058
Other receivables	625	895
Variable annuity assets (separate accounts)	601	548
Other assets	810	757
Goodwill	186	186
Total assets	$ 36,211	$ 35,838
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 6,117	$ 6,520
Unearned premiums	1,496	1,484
Annuity benefits accumulated	16,064	15,420
Life, accident and health reserves	1,739	1,727
Payable to reinsurers	292	475
Liabilities of managed investment entities	2,672	2,787
Long-term debt	931	934
Variable annuity liabilities (separate accounts)	601	548
Other liabilities	1,567	1,386
Total liabilities	31,479	31,281
Shareholders equity:		
Common Stock, no par value		
- 200,000,000 shares authorized		

- 97,177,820 and 97,846,402 shares outstanding	97	98
Capital surplus	1,126	1,121
Retained earnings:		
Appropriated managed investment entities	145	173
Unappropriated	2,498	2,439
Accumulated other comprehensive income, net of tax	714	580
Total shareholders equity	4,580	4,411
Noncontrolling interests	152	146
Total equity	4,732	4,557
Total liabilities and equity	$ 36,211	$ 35,838

2

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)

(In Millions, Except Per Share Data)

	Three months ended March 31, 2012	Three months ended March 31, 2011 (as adjusted)
Revenues:		
Property and casualty insurance premiums	$ 603	$ 599
Life, accident and health premiums	105	110
Investment income	322	300
Realized gains (losses) on:		
Securities (*)	44	
Subsidiaries		(3)
Income (loss) of managed investment entities:		
Investment income	29	25
Loss on change in fair value of assets/liabilities	(29)	(33)
Other income	39	41
Total revenues	1,113	1,039
Costs and Expenses:		
Property and casualty insurance:		
Losses and loss adjustment expenses	344	341
Commissions and other underwriting expenses	211	203
Annuity benefits	130	116
Life, accident and health benefits	92	96
Annuity and supplemental insurance acquisition expenses	47	50
Interest charges on borrowed money	21	21
Expenses of managed investment entities	19	18
Other operating and general expenses	103	92
Total costs and expenses	967	937
Operating earnings before income taxes	146	102
Provision for income taxes	58	48
Net earnings, including noncontrolling interests	88	54
Less: Net earnings (loss) attributable to noncontrolling interests	(25)	(34)
Net Earnings Attributable to Shareholders	$ 113	$ 88
Earnings Attributable to Shareholders per Common Share:		
Basic	$ 1.16	$ .84
Diluted	$ 1.14	$ .83
Average number of Common Shares:		
Basic	97.7	104.6

Diluted	99.4	106.2
Cash dividends per Common Share	$ .175	$ .1625

(*) Consists of the following:		
Realized gains before impairments	$ 48	$ 10
Losses on securities with impairment	(5)	(7)
Non-credit portion recognized in other comprehensive income (loss)	1	(3)
Impairment charges recognized in earnings	(4)	(10)
Total realized gains on securities	$ 44	$

3

[Table of Contents](#)

AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)

(In Millions)

	Three months ended March 31, 2012	2011
Net earnings, including noncontrolling interests	$ 88	$ 54
Other comprehensive income, net of tax:		
Net unrealized gains on securities:		
Unrealized holding gains on securities arising during the period	158	18
Reclassification adjustment for realized gains included in net earnings	(28)	
Total net unrealized gains on securities	130	18
Foreign currency translation adjustments	7	7
Pension and other postretirement plans adjustments	1	
Other comprehensive income, net of tax	138	25
Total comprehensive income, net of tax	226	79
Less: Comprehensive income (loss) attributable to noncontrolling interests	(21)	(34)
Comprehensive income attributable to shareholders	$ 247	$ 113

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)

(Dollars in Millions)

	Shareholders Equity							
			Retained Earnings					
	Common Shares	Common Stock and Capital Surplus	Appro.	Unappro.	Accum. Other Comp Inc.(Loss)	Total	Noncon-trolling Interests	Total Equity
Balance at December 31, 2011, as adjusted	97,846,402	$ 1,219	$ 173	$ 2,439	$ 580	$ 4,411	$ 146	$ 4,557
Net earnings				113		113	(25)	88
Other comprehensive income					134	134	4	138
Allocation of losses of managed investment entities			(28)			(28)	28	
Dividends on Common Stock				(17)		(17)		(17)
Shares issued:								
Exercise of stock options	551,219	14				14		14
Other benefit plans	250,072	5				5		5
Dividend reinvestment plan	3,916							
Stock-based compensation expense		4				4		4
Shares acquired and retired	(1,473,789)	(19)		(37)		(56)		(56)
Other							(1)	(1)
Balance at March 31, 2012	97,177,820	$ 1,223	$ 145	$ 2,498	$ 714	$ 4,580	$ 152	$ 4,732
Balance at December 31, 2010	105,168,366	$ 1,271	$ 197	$ 2,523	$ 479	$ 4,470	$ 150	$ 4,620
Cumulative effect of accounting change				(155)	16	(139)		(139)
Balance at December 31, 2010, as adjusted	105,168,366	1,271	197	2,368	495	4,331	150	4,481
Net earnings				88		88	(34)	54
Other comprehensive income					25	25		25
Allocation of losses of managed investment entities			(35)			(35)	35	
Dividends on Common Stock				(17)		(17)		(17)
Shares issued:								
Exercise of stock options	436,127	11				11		11
Other benefit plans	332,337	7				7		7
Dividend reinvestment plan	4,043							
Stock-based compensation expense		3				3		3
Shares acquired and retired	(2,457,721)	(30)		(54)		(84)		(84)
Other							(2)	(2)
Balance at March 31, 2011	103,483,152	$ 1,262	$ 162	$ 2,385	$ 520	$ 4,329	$ 149	$ 4,478

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

	Three months ended March 31, 2012	2011 (as adjusted)
Operating Activities:		
Net earnings, including noncontrolling interests	$ 88	$ 54
Adjustments:		
Depreciation and amortization	46	49
Annuity benefits	130	116
Realized (gains) losses on investing activities	(44)	3
Net purchases of trading securities	(13)	(5)
Deferred annuity and life policy acquisition costs	(60)	(51)
Change in:		
Reinsurance and other receivables	535	446
Other assets	(30)	15
Insurance claims and reserves	(373)	(202)
Payable to reinsurers	(183)	(92)
Other liabilities	(3)	59
Managed investment entities assets/liabilities	(86)	(12)
Other operating activities, net	3	9
Net cash provided by operating activities	10	389
Investing Activities:		
Purchases of:		
Fixed maturities	(951)	(1,044)
Equity securities	(59)	(34)
Mortgage loans	(39)	(91)
Real estate, property and equipment	(44)	(20)
Proceeds from:		
Maturities and redemptions of fixed maturities	514	590
Repayments of mortgage loans	2	10
Sales of fixed maturities	131	291
Sales of equity securities	65	6
Managed investment entities:		
Purchases of investments	(566)	(352)
Proceeds from sales and redemptions of investments	774	400
Other investing activities, net	(10)	(13)
Net cash used in investing activities	(183)	(257)
Financing Activities:		
Annuity receipts	804	672
Annuity surrenders, benefits and withdrawals	(348)	(311)
Reductions of long-term debt	(3)	(3)
Issuances of managed investment entities liabilities	359	

Retirement of managed investment entities liabilities	(489)	(4)
Issuances of Common Stock	14	11
Repurchases of Common Stock	(56)	(84)
Cash dividends paid on Common Stock	(17)	(16)
Other financing activities, net	7	3
Net cash provided by financing activities	271	268
Net Change in Cash and Cash Equivalents	98	400
Cash and cash equivalents at beginning of period	1,324	1,099
Cash and cash equivalents at end of period	$ 1,422	$ 1,499

6

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO NOTES

Accounting Policies

A. Accounting Policies

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

Certain reclassifications have been made to prior periods to conform to the current year s presentation. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to March 31, 2012, and prior to the filing date of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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.

Accounting Standards Adopted in 2012 Effective January 1, 2012, AFG retrospectively adopted Accounting Standards Update (ASU) 2010-26 that addresses which costs related to issuing or renewing insurance contracts qualify for deferral. To qualify for deferral, the guidance specifies that a cost must be directly related to the successful acquisition of an insurance contract. The financial statements for prior periods have been adjusted to reflect the adoption of the new standard.

The impact of adoption on amounts previously reported is shown in the table below (in millions, except per share data):

		December 31, 2011
Deferred policy acquisition costs		
As previously reported	$	1,105
As adjusted		901
Net deferred tax liability (included in other liabilities)		
As previously reported	$	203
As adjusted		133
Shareholders equity		
As previously reported	$	4,545
As adjusted		4,411

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

	2011				
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total Year
Net earnings attributable to shareholders					
As previously reported	$ 83	$ 55	$ 96	$ 109	$ 343
As adjusted	88	48	97	109	342
Diluted earnings per Common Share					
As previously reported	$ .79	$ .52	$ .94	$ 1.10	$ 3.33
As adjusted	.83	.46	.95	1.09	3.32

Effective January 1, 2012, AFG retrospectively adopted ASU 2011-05, which eliminates the option to report other comprehensive income in the Statement of Changes in Equity. As permitted by the standard, comprehensive income is presented herein in a separate statement immediately following the Statement of Earnings. This new presentation does not change the measurement of net earnings, other comprehensive income or earnings per share, and accordingly, had no impact on AFG s results of operations or financial position.

Effective January 1, 2012, AFG adopted ASU 2011-04, which clarifies the application of existing fair value measurement and amends certain disclosure requirements. Disclosures required by the guidance are included in Note C. The impact of adoption was not material to AFG s results of operations or financial position.

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability (inputs) are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG s assumptions about the assumptions market participants would use in pricing the asset or liability. AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in the first quarter of 2012 or 2011.

Investments Fixed maturity and equity securities classified as available for sale are reported at fair value with unrealized gains and losses included in accumulated other comprehensive income in AFG s Balance Sheet. Fixed maturity and equity securities classified as trading are reported at fair value with changes in unrealized holding gains or losses during the period included in investment income. Mortgage and policy loans are carried primarily at the aggregate unpaid balance.

Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities (MBS) 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.

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses)) and the cost basis of that investment is reduced. If management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other-than-temporary impairment is measured by comparing a security s amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value.

Derivatives Derivatives included in AFG s Balance Sheet are recorded at fair value and consist primarily of (i) components of certain fixed maturity securities (primarily interest-only MBS) and (ii) 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 earnings.

Goodwill Goodwill represents the excess of cost of subsidiaries over AFG s equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. Under guidance adopted in 2011, an entity is only required to complete the quantitative annual goodwill impairment test on a reporting unit if the entity determines (through qualitative analysis) that it is more likely than not that the reporting unit s fair value is less than its carrying amount.

Reinsurance Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG s property and casualty insurance subsidiaries report as assets (a) the estimated reinsurance recoverable on paid and unpaid losses, including an estimate for losses incurred but not reported, and (b) amounts paid to reinsurers applicable to the unexpired terms of policies in force. Payable to reinsurers includes ceded premiums due to reinsurers as well as ceded premiums retained by AFG s property and casualty insurance subsidiaries under contracts to fund ceded losses as they become due. AFG s insurance subsidiaries also assume reinsurance from other companies. Earnings on reinsurance assumed is recognized based on information received from ceding companies.

Certain annuity and supplemental insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby the subsidiaries retain the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be adjusted to fair value) because the yield on the payables is based on specific blocks of the ceding companies assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to these transactions are classified as trading. The adjustment to fair value on the embedded derivatives offsets the investment income recorded on the adjustment to fair value of the related trading portfolios.

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

Deferred Policy Acquisition Costs (DPAC) Policy acquisition costs (principally commissions, premium taxes and certain policy issuance costs) directly related to the successful acquisition of an insurance contract are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses. As discussed above under Accounting Standards Adopted in 2012, AFG s accounting for DPAC changed effective January 1, 2012, and amounts previously reported have been adjusted retrospectively.

For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses and unamortized acquisition costs exceed the related unearned premiums. A premium deficiency is first recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability is accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

DPAC related to annuities 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. Expected gross profits consist principally of estimated future investment margin (estimated future net investment income less interest credited on policyholder funds) and surrender, mortality, and other life and variable annuity policy charges, less death and annuitization benefits in excess of account balances and estimated future policy administration expenses. 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 (losses).

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 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, a component of accumulated other comprehensive income in AFG s Balance Sheet.

DPAC includes the present value of future profits on business in force of annuity and supplemental insurance companies acquired (PVFP). PVFP 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. PVFP 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.

Managed Investment Entities A company is considered the primary beneficiary of, and therefore must consolidate, a variable interest entity (VIE) based primarily on its ability to direct the activities of the VIE that most significantly impact that entity s economic performance and the obligation to absorb losses of, or receive benefits from, the entity that could potentially be significant to the VIE.

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

AFG manages, and has investments in, collateralized loan obligations (CLOs) that are VIEs (see *Note G Managed Investment Entities*). Both the management fees (payment of which are subordinate to other obligations of the CLOs) and the investments in the CLOs are considered variable interests. AFG has determined that it is the primary beneficiary of the CLOs because (i) its role as asset manager gives it the power to direct the activities that most significantly impact the economic performance of the CLOs and (ii) it has exposure to CLO losses (through its investments in the CLO debt tranches) and the right to receive benefits (through its subordinated management fees and returns on its investments), both of which could potentially be significant to the CLOs.

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG s Balance Sheet. AFG has elected the fair value option for reporting on the CLO assets and liabilities to improve the transparency of financial reporting related to the CLOs. The excess of fair value of the CLOs assets over the fair value of the liabilities is recorded in AFG s Balance Sheet as appropriated retained earnings managed investment entities, representing amounts that ultimately will inure to the benefit of the CLO debt holders.

The net gain or loss from accounting for the CLO assets and liabilities at fair value is separately presented in AFG s Statement of Earnings. CLO earnings attributable to AFG s shareholders represent the change in fair value of AFG s investments in the CLOs (including distributions) and management fees earned. All other CLO earnings (losses) are not attributable to AFG s shareholders and will ultimately inure to the benefit of the other CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG s Statement of Earnings and in appropriated retained earnings managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2022), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

Unpaid Losses and Loss Adjustment Expenses The net liabilities stated for unpaid claims and for expenses of investigation and adjustment of unpaid claims are based upon (a) the accumulation of case estimates for losses reported prior to the close of the accounting period on direct business written; (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of unreported losses (including possible development on known claims) based on past experience; (d) estimates based on experience of expenses for investigating and adjusting claims; and (e) the current state of the law and coverage litigation. Establishing reserves for asbestos, environmental and other mass tort claims involves considerably more judgment than other types of claims due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage.

Loss reserve liabilities are subject to the impact of changes in claim amounts and frequency and other factors. Changes in estimates of the liabilities for losses and loss adjustment expenses are reflected in the Statement of Earnings in the period in which determined. Despite the variability inherent in such estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

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

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses and excess benefits expected to be paid on future deaths and annuitizations (EDAR). The liability for EDAR is accrued for and modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that amounts are determined in relation to the present value of total expected assessments. Total expected assessments consist principally of estimated future investment margin, surrender, mortality, and other life and variable annuity policy charges, and unearned revenues once they are recognized as income.

Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati.

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. Claim reserves and liabilities established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

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

AFG s variable annuity contracts contain a guaranteed minimum death benefit (GMDB) to be paid if the policyholder dies before the annuity payout period commences. In periods of declining equity markets, the GMDB may exceed the value of the policyholder s account. A GMDB liability is established for future excess death benefits using assumptions together with a range of reasonably possible scenarios for investment fund performance that are consistent with DPAC capitalization and amortization assumptions.

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 information 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.

Noncontrolling Interests For Balance Sheet purposes, noncontrolling interests represents the interests of shareholders other than AFG in consolidated entities. In the Statement of Earnings, net earnings and losses attributable to noncontrolling interests represents such shareholders interest in the earnings and losses of those entities.

Income Taxes 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. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized.

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS   CONTINUED

AFG records a liability for the inherent uncertainty in quantifying its income tax provisions. Related interest and penalties are recognized as a component of tax expense.

Stock-Based Compensation All share-based grants are recognized as compensation expense on a straight-line basis over their vesting periods based on their calculated fair value at the date of grant. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options. See *Note J - Shareholders Equity* for further information.

Benefit Plans AFG provides retirement benefits to qualified employees of participating companies through the AFG 401(k) Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Company contributions are expensed in the year for which they are declared. AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period employees earn such benefits.

Earnings Per Share Basic earnings per share is calculated using the weighted average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes adjustments to weighted average common shares of 1.7 million for the first quarter of 2012 and 1.6 million for the first quarter of 2011 related to stock-based compensation plans.

AFG s weighted average diluted shares outstanding excludes 1.5 million for the first quarter of 2012 and 1.8 million for the first quarter of 2011 in anti-dilutive potential common shares related to stock compensation plans. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2012 and 2011 periods.

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.

Segments of Operations

B. Segments of Operations

AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity and supplemental insurance and (iii) other, which includes holding company costs and amounts attributable to the noncontrolling interests of the managed investment entities.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, executive liability, umbrella and excess liability, customized programs for small to mid-sized businesses and workers compensation, and (iii) Specialty financial, which includes risk management insurance programs for lending and leasing institutions (including collateral and mortgage protection insurance), surety and fidelity products and trade credit insurance. AFG s annuity and supplemental insurance business markets traditional fixed and indexed annuities and a variety of supplemental insurance products such as Medicare supplement.

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

AFG s reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

The following tables (in millions) show AFG s revenues and operating earnings before income taxes by significant business segment and sub-segment.

	Three months ended March 31, 2012	2011
Revenues		
Property and casualty insurance:		
Premiums earned:		
Specialty		
Property and transportation	$ 263	$ 255
Specialty casualty	220	216
Specialty financial	103	112
Other	17	16
Total premiums earned	603	599
Investment income	71	75
Realized gains	31	
Other income	13	15
Total property and casualty insurance	718	689
Annuity and supplemental insurance:		
Investment income	252	228
Life, accident and health premiums	105	110
Realized gains (losses)	13	(3)
Other income	26	24
Total annuity and supplemental insurance	396	359
Other	(1)	(9)
Total revenues	$ 1,113	$ 1,039
Operating Earnings Before Income Taxes		
Property and casualty insurance:		
Underwriting:		
Specialty		
Property and transportation	$ 27	$ 36
Specialty casualty	4	1
Specialty financial	16	16
Other	1	2
Total underwriting	48	55
Investment and other income, net	55	69

Realized gains	31	
Total property and casualty insurance	134	124
Annuity and supplemental insurance:		
Operations	67	54
Realized gains (losses)	13	(3)
Total annuity and supplemental insurance	80	51
Other (*)	(68)	(73)
Total operating earnings before income taxes	$ 146	$ 102

(*) Includes holding company expenses and $28 million and $35 million in losses of managed investment entities attributable to noncontrolling interests for the first quarter of 2012 and 2011, respectively.

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Fair Value Measurements

C. Fair Value Measurements

Accounting standards for measuring fair value are based on inputs used in estimating fair value. The three levels of the hierarchy are as follows:

Level 1 Quoted prices for identical assets or liabilities in active markets (markets in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis). AFG s Level 1 financial instruments consist primarily of publicly traded equity securities and highly liquid government bonds for which quoted market prices in active markets are available and short-term investments of managed investment entities.

Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (markets in which there are few transactions, the prices are not current, price quotations vary substantially over time or among market makers, or in which little information is released publicly); and valuations based on other significant inputs that are observable in active markets. AFG s Level 2 financial instruments include separate account assets, corporate and municipal fixed maturity securities, mortgage-backed securities (MBS) and investments of managed investment entities priced using observable inputs. Level 2 inputs include benchmark yields, reported trades, corroborated broker/dealer quotes, issuer spreads and benchmark securities. When non-binding broker quotes can be corroborated by comparison to similar securities priced using observable inputs, they are classified as Level 2.

Level 3 Valuations derived from market valuation techniques generally consistent with those used to estimate the fair values of Level 2 financial instruments in which one or more significant inputs are unobservable or when the market for a security exhibits significantly less liquidity relative to markets supporting Level 2 fair value measurements. The unobservable inputs may include management s own assumptions about the assumptions market participants would use based on the best information available in the circumstances. AFG s Level 3 is comprised of financial instruments, including liabilities of managed investment entities, whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, observable market information.

AFG s management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. AFG s internal investment professionals are a group of approximately 20 analysts whose primary responsibility is to manage AFG s investment portfolio. These professionals monitor individual investments as well as overall industries and are active in the financial markets on a daily basis. The group is led by AFG s chief investment officer, who reports directly to one of the Co-CEOs. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by AFG s internal investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, these investment managers consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. In addition, the Company communicates directly with the pricing service regarding the methods and assumptions used in pricing, including verifying, on a test basis, the inputs used by the service to value specific securities.

Table of Contents

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Assets and liabilities measured and carried at fair value in the financial statements are summarized below (in millions):

	Level 1	Level 2	Level 3	Total
March 31, 2012				
Assets:				
Available for sale (AFS) fixed maturities:				
U.S. Government and government agencies	$ 235	$ 155	$	$ 390
States, municipalities and political subdivisions		3,844	72	3,916
Foreign government		260		260
Residential MBS		3,804	314	4,118
Commercial MBS		2,880	20	2,900
All other corporate	8	10,264	515	10,787
Total AFS fixed maturities	243	21,207	921	22,371
Trading fixed maturities		456	1	457
Equity securities	955	75	24	1,054
Assets of managed investment entities (MIE)	245	2,643	64	2,952
Variable annuity assets (separate accounts) (a)		601		601
Other investments		142		142
Total assets accounted for at fair value	$ 1,443			