AMERICAN FINANCIAL GROUP INC
Form 10-Q
August 08, 2008

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 June 30, 2008	Commission File

No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

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

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of
the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements
for the past 90 days. Yes _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 August 1, 2008, there were 115,193,710 shares of the Registrant's Common Stock outstanding, excluding
14.9 million shares owned by subsidiaries.

AMERICAN FINANCIAL GROUP, INC.

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PART I

ITEM I - FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (unaudited)

(Dollars In Millions)

	June 30, 2008	December 31, 2007
Assets:		
Cash and cash equivalents	$ 843.1	$ 815.9
Investments:		
Fixed maturities:		
Available for sale - at fair value		
(amortized cost - $15,767.3 and $15,188.1)	15,295.7	15,140.7
Trading - at fair value	326.3	274.1
Equity securities - at fair value		
(cost - $734.6 and $914.5)	732.7	923.3
Mortgage loans	348.9	358.8
Policy loans	277.2	273.2
	299.0	268.1
Real estate and other investments		
Total cash and investments	18,122.9	18,054.1

Recoverables from reinsurers and prepaid reinsurance premiums	3,677.0	3,664.1
Agents' balances and premiums receivable	751.6	560.6
Deferred policy acquisition costs	1,460.9	1,394.4
Other receivables	324.8	475.4
Variable annuity assets (separate accounts)	601.5	692.5
Prepaid expenses and other assets	1,009.2	762.0
	209.7	204.4
Goodwill		
	$26,157.6	$25,807.5
Liabilities and Capital:		
Unpaid losses and loss adjustment expenses	$ 6,221.7	$ 6,168.4
Unearned premiums	1,812.4	1,668.2
Annuity benefits accumulated	10,387.1	10,096.6
Life, accident and health reserves	1,531.5	1,483.7
Payable to reinsurers	354.3	363.8
Long-term debt	997.5	936.9
Variable annuity liabilities (separate accounts)	601.5	692.5
Accounts payable, accrued expenses and other liabilities	1,254.2	1,251.4
Total liabilities	23,160.2	22,661.5
Minority interest	122.6	99.9
Shareholders' Equity:		
Common Stock, no par value		
- 200,000,000 shares authorized		
- 115,066,902 and 113,499,080 shares outstanding	115.1	113.5
Capital surplus	1,219.6	1,186.5
Retained earnings	1,811.2	1,733.5
Accumulated other comprehensive income (loss), net of tax	(271.1	12.6
)		
Total shareholders' equity	2,874.8	3,046.1
	$26,157.6	$25,807.5

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EARNINGS (unaudited)

(In Millions, Except Per Share Data)

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Income:				
Property and casualty insurance premiums	$ 618.8	$ 633.5	$1,253.8	$1,273.3
Life, accident and health premiums	107.9	103.4	216.6	210.0
Investment income	270.9	249.0	537.2	494.8
Realized gains (losses) on securities	(63.1)	14.0	(143.4)	18.7
Other income	96.2	92.0	180.7	174.7
	1,030.7	1,091.9	2,044.9	2,171.5
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	343.1	354.8	634.0	681.7
Commissions and other underwriting expenses	211.0	208.5	433.0	418.7
Annuity benefits	81.8	90.4	186.7	179.2
Life, accident and health benefits	85.3	85.4	172.7	170.9
Annuity and supplemental insurance acquisition expenses	54.7	40.7	94.8	85.2
Interest charges on borrowed money	17.3	17.7	36.0	35.8
Other operating and general expenses	137.5	182.4	261.7	293.9
	930.7	979.9	1,818.9	1,865.4
Operating earnings before income taxes	100.0	112.0	226.0	306.1
Provision for income taxes	37.0	36.6	81.9	108.6
Net operating earnings	63.0	75.4	144.1	197.5
Minority interest expense	(2.7)	(10.1)	(7.8)	(18.6)

Earnings from continuing operations	60.3	65.3	136.3	178.9
Discontinued operations, net of tax	-	1.7	-	1.7
Net Earnings	$ 60.3	$ 67.0	$ 136.3	$ 180.6
Basic earnings per Common Share:				
Continuing operations	$.53	$.55	$1.20	$1.50
Discontinued operations	-	.01	-	.01
Net earnings available to Common Shares	$.53	$.56	$1.20	$1.51
Diluted earnings per Common Share:				
Continuing operations	$.52	$.53	$1.16	$1.46
Discontinued operations	-	.01	-	.01
Net earnings available to Common Shares	$.52	$.54	$1.16	$1.47
Average number of Common Shares:				
Basic	113.3	119.6	113.4	119.5
Diluted	116.3	122.4	116.9	122.4
Cash dividends per Common Share	$.125	$.10	$.25	$.20

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (unaudited)

(Dollars in Millions)

Common Shares	Common Stock and Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total

Balance at December 31, 2007	113,499,080	$1,300.0	$1,733.5	$ 12.6	$3,046.1
Net earnings	-	-	136.3	-	136.3
Other comprehensive income, net of tax:					
Change in unrealized gain (loss) on securities	-	-	-	(281.9)	(281.9)
Change in foreign currency translation	-	-	-	(1.9)	(1.9)
Change in unrealized pension and other Postretirement benefits				.1	.1
Total comprehensive income (loss)					(147.4)
Dividends on Common Stock	-	-	(28.3)	-	(28.3)
Shares issued:					
Redemption of convertible notes	2,364,640	24.4	-	-	24.4
Exercise of stock options	943,514	19.1	-	-	19.1
Other benefits plans	167,541	4.7	-	-	4.7
Dividend reinvestment plan	142,759	3.7	-	-	3.7
Other stock-based compensation expense	-	5.1	-	-	5.1
Shares acquired and retired	(1,803,000)	(20.7)	(26.7)	-	(47.4)
Shares tendered in option exercises	(247,632)	(2.8)	(3.6)	-	(6.4)
Capital transactions of subsidiaries	-	1.2	-	-	1.2
Balance at June 30, 2008	115,066,902	$1,334.7	$1,811.2	($271.1)	$2,874.8

Balance at December 31, 2006	119,303,928	$1,339.8	$1,533.6	$ 55.5	$2,928.9
Cumulative effect of accounting change	-	-	(14.9)	-	(14.9)
Net earnings	-	-	180.6	-	180.6
Other comprehensive income, net of tax:					
Change in unrealized gain (loss) on securities	-	-	-	(112.7)	(112.7)
Change in foreign currency translation	-	-	-	12.7	12.7
Change in unrealized pension and other Postretirement benefits	-	-	-	2.8	2.8
Total comprehensive income					83.4
Dividends on Common Stock	-	-	(23.9)	-	(23.9)
Shares issued:					
Exercise of stock options	590,784	13.9	-	-	13.9

Other benefit plans	173,910	6.0	-	-	6.0
Dividend reinvestment plan	80,224	2.7	-	-	2.7
Other stock-based compensation expense	-	5.1	-	-	5.1
Shares acquired and retired	(855,939)	(9.6)	(19.1)	-	(28.7)
Shares tendered in option exercises	(26,498)	(.3)	(.6)	-	(.9)
Capital transactions of subsidiaries	-	(1.5	-	-	(1.5
	)			)	
Balance at June 30, 2007	119,266,409	$1,356.1	$1,655.7	($ 41.7)	$2,970.1

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

	Six months ended June 30,	
	2008	2007
Operating Activities:		
Net earnings	$ 136.3	$ 180.6
Adjustments:		
Minority interest	7.8	18.9
Depreciation and amortization	124.9	95.2
Annuity benefits	186.7	179.2
Realized (gains) losses on investing activities	137.6	(35.1)
Net purchases/sales of trading securities	27.5	(41.0)
Deferred annuity and life policy acquisition costs	(95.6)	(103.2)
Decrease	56.6	(19.7)
(increase) in reinsurance and other receivables		
Increase in other assets	(43.8)	(195.6)
Increase in insurance claims and reserves	78.1	209.2
Decrease in payable to reinsurers	(11.1)	(12.0)
Decrease in other liabilities	(59.5)	(15.6)
Other, net	9.7	11.0

Net cash provided by operating activities	555.2	271.9
Investing Activities:		
Purchases of and additional investments in:		
Fixed maturity investments	(3,722.6)	(1,946.4)
Equity securities	(116.6)	(224.4)
Subsidiaries	(112.2)	(1.7)
Real estate, property and equipment	(25.0)	(13.8)
Maturities and redemptions of fixed maturity investments	1,253.9	667.3
Sales of:		
Fixed maturity investments	1,876.6	433.4
Equity securities	155.3	97.6
Real estate, property and equipment	6.5	22.9
Decrease in securities lending collateral	26.0	5.2
Cash and cash equivalents of businesses acquired	44.3	-
Increase in other investments	(14.3	(54.8
)	)	
Net cash used in investing activities	(628.1	(1,014.7
)	)	
Financing Activities:		
Annuity receipts	789.6	817.4
Annuity surrenders, benefits and withdrawals	(693.9)	(691.7)
Net transfers from variable annuity assets	27.7	31.9
Additional long-term borrowings	530.0	92.0
Reductions of long-term debt	(469.5)	(117.3)
Decrease in securities lending obligation	(26.0)	(5.2)
Issuances of Common Stock	14.3	13.3
Repurchases of Common Stock	(47.4)	(28.7)
Cash dividends paid on Common Stock	(24.6)	(21.2)
Other, net	(.1	2.8
)		
Net cash provided by financing activities	100.1	93.3
Net Increase (Decrease) in Cash and Cash Equivalents	27.2	(649.5)
Cash and cash equivalents at beginning of period	815.9	1,329.0

Cash and cash equivalents at end of period	$ 843.1	$ 679.5

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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A. **Accounting Policies**

Basis of Presentation

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

Fair Value Measurements

Effective January 1, 2008, AFG adopted Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements." SFAS 157 defines 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 standard establishes 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. In 2008, the FASB delayed the effective date of SFAS 157 for all nonrecurring fair value measurements of nonfinancial assets and liabilities until fiscal years beginning after November 15, 2008. Adoption of SFAS 157 did not have a significant impact on AFG's financial condition or results of operations.

Investments

Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in a separate component of shareholders' equity. 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. Loans receivable are carried primarily at the aggregate unpaid balance.

Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

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.

Certain AFG subsidiaries loan fixed maturity and equity securities to other institutions for short periods of time. The borrower is required to provide collateral on which AFG earns investment income, net of a fee to the lending agent. AFG records the collateral held (included in other assets) in its Balance Sheet at fair value. The obligation to return the collateral is included in other liabilities. The securities loaned remain a recorded asset on AFG's Balance Sheet. The fair value of collateral held was approximately $108 million at June 30, 2008, and $139 million at December 31, 2007. The fair value of securities loaned plus accrued interest was approximately $113 million and $139 million at those dates.

Derivatives

Derivatives included in AFG's Balance Sheet are recorded at fair value and consist primarily of (i) components of certain fixed maturity securities 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 current 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.

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. Income on reinsurance assumed is recognized based on reports 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.

Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses, unamortized acquisition costs and policy maintenance costs exceed the related unearned premiums. A premium deficiency would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency was greater than unamortized acquisition costs, a liability would be accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

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

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

DPAC includes the present value of future profits on business in force of 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.

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.

Life, Accident and Health Reserves

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

Variable Annuity Assets and Liabilities

Separate accounts related to variable annuities represent the 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.

Premium Recognition

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

Minority Interest

For Balance Sheet purposes, minority interest represents the interests of noncontrolling shareholders in consolidated entities. In the Statement of Earnings, minority interest expense represents such shareholders' interest in the earnings 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. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

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.

AFG implemented FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" ("FIN 48") on

January 1, 2007. FIN 48 sets forth criteria for recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 requires that companies recognize the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest, penalties, accounting in interim periods and disclosure. The cumulative effect of applying FIN 48 was recorded as a reduction to retained earnings at January 1, 2007 and is shown separately in the Statement of Changes in Shareholders' Equity.

Stock-Based Compensation

All share-based grants are recognized as compensation expense 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 G - "Shareholders' Equity"* for further information on stock options.

Benefit Plans

AFG provides retirement benefits to qualified employees of participating companies through the AFG Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. 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 (in millions):

	Three months ended June 30,		Six months ended June 30,	
	2008	2007	2008	2007
Adjustments to net earnings:				
Dilution of majority-owned subsidiaries	-	($.4)	($.1)	($.9)
Assumed issuance of shares under deferred compensation plan	-	-	(.2)	(.1)
Adjustments to weighted average common shares:				
Stock-based compensation plans	1.7	2.8	1.9	2.9
Convertible notes	1.3	-	1.6	-

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