

GREAT AMERICAN FINANCIAL RESOURCES INC  
Form 10-Q  
November 08, 2006

---

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For the Quarterly Period Ended  
September 30, 2006

Commission File

No. 1-11632

Incorporated under  
the Laws of Delaware

IRS Employer I.D.

No. 06-1356481

250 East Fifth Street, Cincinnati, Ohio 45202  
(513) 333-5300

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

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

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, or a non-accelerated filer: Large Accelerated Filer\_\_\_ Accelerated Filer X Non-Accelerated Filer\_\_\_

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

As of November 1, 2006, there were 47,501,994 shares of the Registrant's Common Stock outstanding.

---

Page 1 of 33

GREAT AMERICAN FINANCIAL RESOURCES, INC.

TABLE OF CONTENTS

		<u>Page</u>
<b><u>Part I</u></b>	Financial Information	
	Financial Statements:	
<u>Item 1</u>	Consolidated Balance Sheet	2
	Consolidated Income Statement	3
	Consolidated Statement of Changes in Stockholders' Equity	4
	Consolidated Statement of Cash Flows	5
	Notes to Consolidated Financial Statements	6
<u>Item 2</u>	Management's Discussion and Analysis of Financial Condition	
	and Results of Operations	22
<u>Item 3</u>	Quantitative and Qualitative Disclosure of Market Risk	32
<u>Item 4</u>	Controls and Procedures	32
<b><u>Part II</u></b>	Other Information	
	Unregistered Sales of Equity Securities and Use of Proceeds	33

<u>Item 2</u>	Exhibits	33
<u>Item 6</u>	Signature	33
Exhibit Index		
<u>Exhibit 31(a)</u>	Certification of the Chief Executive Officer Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002	E-1
<u>Exhibit 31(b)</u>	Certification of the Chief Financial Officer Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002	E-2
<u>Exhibit 32</u>	Certification of the Chief Executive Officer and the Chief Financial Officer Pursuant to 18 USC Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	E-3

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

PART I

ITEM 1 - FINANCIAL STATEMENTS

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET - (UNAUDITED)

(Dollars in millions)

	September 30, <u>2006</u>	December 31, <u>2005</u>
Assets		
Investments:		
Fixed maturities:		
Available-for-sale - at fair value (amortized cost - \$8,898.1 and \$8,825.9)	\$ 8,908.3	\$ 8,930.1
Trading securities - at fair value	279.8	271.9
Equity securities - at fair value		

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

(cost - \$236.6 and \$185.7)	244.8	191.4
Mortgage loans on real estate	169.1	38.4
Real estate	77.3	118.3
Policy loans	264.9	258.7
Short-term investments	<u>428.1</u>	<u>132.6</u>
Total investments	10,372.3	9,941.4
Cash	90.9	21.7
Accrued investment income	117.2	117.6
Unamortized insurance acquisition costs	900.9	835.9
Reinsurance recoverable	677.4	257.3
Other assets	160.4	104.6
Variable annuity assets (separate accounts)	<u>663.5</u>	<u>643.5</u>
	<u>\$12,982.6</u>	<u>\$11,922.0</u>
Liabilities and Stockholders' Equity		
Annuity benefits accumulated	\$ 9,180.7	\$ 8,417.3
Unearned revenue	106.0	118.2
Life, accident and health reserves	1,396.3	1,088.0
Long-term debt	275.2	341.8
Payable to affiliates, net	105.7	119.9
Deferred tax liability on unrealized gains	6.9	31.0
Accounts payable, accrued expenses and other liabilities	203.0	155.6
Variable annuity liabilities (separate accounts)	<u>663.5</u>	<u>643.5</u>
Total liabilities	11,937.3	10,915.3
Stockholders' Equity:		
Common Stock, \$1 par value		
-100,000,000 shares authorized		
-47,471,248 and 47,256,092 shares outstanding	47.5	47.3
Capital surplus	413.8	409.0
Retained earnings	571.2	489.2
Unrealized gains on marketable securities, net	<u>12.8</u>	<u>61.2</u>

Total stockholders' equity	<u>1,045.3</u>	<u>1,006.7</u>
	<u>\$12,982.6</u>	<u>\$11,922.0</u>

2

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED INCOME STATEMENT - (UNAUDITED)

(In millions, except per share amounts)

	<u>Three months ended</u> <u>September 30,</u>		<u>Nine months ended</u> <u>September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
<b>Revenues:</b>				
Life, accident and health premiums	\$ 91.7	\$ 73.2	\$243.7	\$220.3
Net investment income	150.1	137.3	447.7	415.0
Realized gains (losses) on:				
Investments	(2.9)	3.4	(7.5)	4.9
Retirement of debt	(0.1)	-	(4.4)	-
Other income	<u>33.0</u>	<u>22.1</u>	<u>79.3</u>	<u>63.9</u>
	271.8	236.0	758.8	704.1
<b>Costs and Expenses:</b>				
Annuity benefits	88.3	81.0	255.1	244.6
Life, accident and health benefits	69.1	62.5	200.0	182.4
Insurance acquisition expenses	38.3	26.7	100.6	85.0
Interest and debt expenses	5.6	7.1	17.5	20.9

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Other expenses	<u>40.0</u>	<u>38.9</u>	<u>107.2</u>	<u>103.3</u>
	<u>241.3</u>	<u>216.2</u>	<u>680.4</u>	<u>636.2</u>
Operating earnings before income taxes	30.5	19.8	78.4	67.9
Provision for income taxes	<u>10.7</u>	<u>7.0</u>	<u>27.4</u>	<u>23.6</u>
Income from continuing operations	19.8	12.8	51.0	44.3
Discontinued Puerto Rican operations, net of tax	-	3.3	-	14.5
Discontinued hotel operations, net of tax	-	2.7	(0.6)	3.5
Gain on sale of discontinued hotel, net of tax	<u>-</u>	<u>-</u>	<u>31.6</u>	<u>-</u>
Net Income	<u>\$ 19.8</u>	<u>\$ 18.8</u>	<u>\$ 82.0</u>	<u>\$ 62.3</u>
Basic earnings per common share				
:				
Continuing operations	\$ 0.42	\$ 0.27	\$ 1.08	\$ 0.94
Discontinued Puerto Rican operations	-	0.07	-	0.31
Discontinued hotel operations	-	0.06	(0.02)	0.07
Gain on sale of discontinued hotel	<u>-</u>	<u>-</u>	<u>0.67</u>	<u>-</u>
Net income	<u>\$ 0.42</u>	<u>\$ 0.40</u>	<u>\$ 1.73</u>	<u>\$ 1.32</u>
Diluted earnings per common share				
:				
Continuing operations	\$ 0.41	\$ 0.27	\$ 1.06	\$ 0.93
Discontinued Puerto Rican operations	-	0.07	-	0.31
Discontinued hotel operations	-	0.05	(0.01)	0.07
Gain on sale of discontinued hotel	<u>-</u>	<u>-</u>	<u>0.66</u>	<u>-</u>

Net income	<u>\$ 0.41</u>	<u>\$ 0.39</u>	<u>\$ 1.71</u>	<u>\$ 1.31</u>
Average number of common shares:				
Basic	47.4	47.1	47.4	47.1
Diluted	48.0	47.7	48.0	47.5

3

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY - (UNAUDITED)

(In millions)

	Nine months ended <u>September 30,</u>	
	<u>2006</u>	<u>2005</u>
Common Stock:		
Balance at beginning of period	\$ 47.3	\$ 47.1
Common Stock issued	0.3	0.4
Common Stock retired	<u>(0.1)</u>	<u>(0.4)</u>
	)	)
Balance at end of period	<u>\$ 47.5</u>	<u>\$ 47.1</u>
Capital Surplus:		
Balance at beginning of period	\$409.0	\$407.1
Common Stock issued	4.1	5.2
Common Stock retired	(1.5)	(5.8)
Agent stock option grants	0.2	-

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Stock-based compensation expense	<u>2.0</u>	<u>-</u>
Balance at end of period	<u>\$413.8</u>	<u>\$406.5</u>
Retained Earnings:		
Balance at beginning of period	\$489.2	\$424.0
Net income	<u>82.0</u>	<u>62.3</u>
Balance at end of period	<u>\$571.2</u>	<u>\$486.3</u>
Unrealized Gains (Losses), Net:		
Balance at beginning of period	\$ 61.2	\$190.9
Change during period	<u>(48.4</u>	<u>(92.3</u>
	)	)
Balance at end of period	<u>\$ 12.8</u>	<u>\$ 98.6</u>
<hr/>		
Comprehensive Income (Loss)		
Net income	\$ 82.0	\$ 62.3
Other comprehensive income (loss) - change in net unrealized gains (losses) on marketable securities	<u>(48.4</u>	<u>(92.3</u>
	)	)
Comprehensive income (loss)	<u>\$ 33.6</u>	<u>(\$ 30.0)</u>



## GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CASH FLOWS - (UNAUDITED)

(In millions)

	Nine months ended <u>September 30,</u>	
	<u>2006</u>	<u>2005</u>
Cash Flows from Operating Activities:		
Net income	\$ 82.0	\$ 62.3
Adjustments:		
Increase in life, accident and health reserves	15.4	50.0
Benefits to annuity policyholders	255.1	246.5
Amortization of insurance acquisition costs	76.1	77.2
Depreciation and amortization	9.6	24.6
Realized (gains) losses on investments	7.4	(9.7)
Gain on sale of discontinued hotel	(48.7)	-
Realized loss on retirement of debt	4.4	-
Net trading portfolio activity	(10.8)	11.7
Increase in insurance acquisition costs	(114.6)	(94.0)
Decrease (increase) in reinsurance recoverable	(47.6)	0.9
Decrease in other assets	8.7	3.9
Increase in other liabilities	1.2	11.0
Increase (decrease) in payable to affiliates, net	(3.0)	17.3
Other, net	<u>3.7</u>	<u>(0.5)</u>
	)	
Net cash provided by operating activities	<u>238.9</u>	<u>401.2</u>
Cash Flows from Investing Activities:		
Purchases of and additional investments in:		
Fixed maturity investments	(1,236.8)	(1,581.5)
Equity securities	(98.6)	(87.0)
Real estate, mortgage loans and other assets	(43.8)	(38.6)
Purchase of subsidiary	(204.4)	-
Cash and short-term investments of businesses acquired, net	217.8	-
Proceeds received from sale of Puerto Rican operations, net	27.2	-

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Maturities and redemptions of fixed maturity investments	362.2	518.9
Sales of:		
Fixed maturity investments	998.5	774.2
Equity securities	85.5	66.8
Real estate, mortgage loans and other assets	65.7	0.7
Increase in policy loans	<u>(7.8)</u>	<u>(5.4)</u>
	)	)
Net cash provided by (used in) investing activities	<u>165.5</u>	<u>(351.9)</u>
	)	)
Cash Flows from Financing Activities:		
Fixed annuity receipts	914.3	632.5
Annuity surrenders, benefits and withdrawals	(898.6)	(688.4)
Net transfers from variable annuity assets	17.8	10.1
Additions to long-term debt	65.0	-
Reductions of long-term debt	(141.3)	(0.1)
Issuance of Common Stock	4.0	1.9
Retirement of Common Stock	<u>(0.9)</u>	<u>(2.5)</u>
	)	)
Net cash used in financing activities	<u>(39.7)</u>	<u>(46.5)</u>
	)	)
Net increase in cash and short-term investments	364.7	2.8
Beginning cash and short-term investments	<u>154.3</u>	<u>170.2</u>
Ending cash and short-term investments	<u>\$519.0</u>	<u>\$ 173.0</u>

5

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. Description of the Company

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Great American Financial Resources, Inc. ("GAFRI" or "the Company") through its subsidiaries, markets fixed, indexed and variable annuities, and various forms of supplemental insurance through independent agents.

American Financial Group, Inc. ("AFG") and its subsidiaries owned 81% of GAFRI's Common Stock at November 1, 2006.

### • Accounting Policies

#### Basis of Presentation

The accompanying consolidated financial statements for GAFRI 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 ("GAAP").

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

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

#### Investments

Fixed maturity securities and equity securities classified as "available-for-sale" are reported at fair value with unrealized gains and losses reported as a separate component of stockholders' equity. Fixed maturity securities classified as "trading" are reported at fair value with changes in unrealized gains or losses during the period included in investment income. Short-term investments are carried at cost; mortgage loans on real estate are carried at the unpaid principal balance adjusted for any unamortized premium or discounts; and policy loans are carried 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, a provision for impairment is charged to earnings (included in realized gains (losses) on investments) and the cost basis of that investment is reduced.

#### Derivatives

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

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

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Goodwill

Goodwill (included in other assets) represents the excess of cost of subsidiaries over GAFRI's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually.

Reinsurance

In the normal course of business, GAFRI's insurance subsidiaries cede business to other companies under various reinsurance agreements to diversify risk and limit maximum exposure. These transactions may also provide a source of additional capital and liquidity. GAFRI remains obligated for amounts ceded in the event that the reinsurers do not meet their obligations. GAFRI reviews the financial condition of its reinsurers and monitors the amount of reinsurance it has with each company.

Under certain of these agreements, GAFRI's insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby GAFRI retains the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance 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. GAFRI determined that a change in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The Company classifies the securities related to these transactions 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.

Insurance Acquisition Costs and Expenses

Unamortized insurance acquisition costs consist of deferred policy acquisition costs ("DPAC") and the present value of future profits on business in force ("PVFP") of acquired insurance companies.

Insurance acquisition expenses in the income statement reflect primarily the amortization of DPAC and PVFP. In addition, certain commission costs are expensed as paid and included in insurance acquisition expenses. All other uncanceled acquisition costs such as marketing and underwriting expenses are included in "other expenses."

Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, advertising, underwriting, policy issuance and sales expenses that vary with and are primarily related to the production of new business) are deferred to the extent that such costs are deemed recoverable. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

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. 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. 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, net" in the stockholders' 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. Such anticipated premium revenues were estimated using the same assumptions used for computing liabilities for future policy benefits.

Life and health insurance contracts are reviewed periodically using actuarial assumptions revised based on actual and anticipated experience, to determine if there is

7

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

a potential premium deficiency. If any such deficiency exists, it is recognized by a charge to income and a reduction in unamortized acquisition costs.

#### Present Value of Future Profits ("PVFP")

Insurance acquisition costs include the PVFP on business in force of acquired insurance companies, which represents the portion of the costs to acquire such companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition.

The 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 payments for traditional life and health insurance products.

#### 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.

Reserves for two-tier annuities (annuities with different stated account values depending on whether a policyholder annuitizes, dies or surrenders) are recorded at the lower-tier value plus additional reserves for (i) accrued persistency and premium bonuses; and (ii) excess benefits expected to be paid on future deaths and annuitizations ("EDAR") that require payment of the upper-tier value. The liability for EDAR is accrued for and modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that accruals are 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.

Reserves for traditional single-tier fixed annuities are generally recorded at the stated annuitization value. Reserves for indexed annuities are recorded at a value reflecting the fixed guarantees in the product plus the fair value of the equity participation in the contract. Reserves for acquired blocks of business are recorded at fair value.

#### Unearned Revenue

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Policy charges that represent fees for future services are deferred as unearned revenue and recognized as income using the same assumptions and estimated gross profits used to amortize DPAC.

### 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.

The liability for future policy benefits for interest sensitive life and universal life policies is equal to the sum of the accumulated fund balances under such policies.

### Variable Annuity Assets and Liabilities

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

GAFRI'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.

### Life, Accident and Health Premiums and Benefits

For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. Policy reserves have been established in a manner that allocates policy benefits and expenses on a basis consistent with the recognition of related premiums and generally results in the recognition of profits over the premium paying period of the policies.

8

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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. Surrender benefits reduce the account value. Death benefits are expensed when incurred, net of the account value.

### Payable to Subsidiary Trusts

GAFRI has wholly-owned subsidiary trusts that issued preferred securities and, in turn, purchased a like amount of subordinated debt from their parent company. Interest and principal payments from the parent fund the respective trust obligations. GAFRI does not consolidate these subsidiary trusts because they are "variable interest entities" in which GAFRI is not considered to be the primary beneficiary. Accordingly, the subordinated debt due to the trusts is included in "long-term debt" in the Balance Sheet and the related interest expense is included in "interest and debt expenses" in the Consolidated Income Statement.

### Income Taxes

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Until December 31, 2005, GAFRI and its subsidiaries had separate tax allocation agreements with American Financial Group ("AFG") that designated how tax payments were to be shared by members of the tax group. In general, companies computed taxes on a separate return basis without regard to temporary differences. Payments to AFG by GAFRI's insurance subsidiaries were made on a statutory basis.

Under a new tax agreement with AFG that became effective in 2006, GAFRI and its subsidiaries in the tax group will generally pay or recover taxes on a separate company tax return basis. The tax allocation agreements with AFG have not impacted the recognition of income tax expense and income tax payable in GAFRI's financial statements. If the AFG tax group utilizes any of GAFRI's net operating losses or deductions that originated prior to GAFRI's entering AFG's consolidated tax group, AFG will pay to GAFRI an amount equal to the benefit received.

Deferred income tax assets and liabilities are determined based on differences between financial reporting and tax basis and are measured using enacted tax rates. The Company recognizes deferred tax assets if it is more likely than not that a benefit will be realized. Current and deferred tax assets and liabilities of companies in AFG's consolidated tax group are aggregated with other amounts receivable from or payable to affiliates.

### Stock-Based Compensation

Effective January 1, 2006, GAFRI implemented Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment" using the modified prospective method under which prior year amounts are not restated. Under SFAS No. 123(R), companies must recognize compensation expense for all new share-based awards (including employee stock options), and the nonvested portions of prior awards, based on their calculated "fair value" at the date of grant. Beginning in 2006, all share-based grants are recognized as compensation expense over the vesting period. GAFRI uses the Black-Scholes pricing model to measure the fair value of its stock options.

Prior to the implementation of SFAS No. 123(R), GAFRI accounted for stock options and other stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees." Under this method, no compensation expense for stock option grants was recognized because options were granted at exercise prices equal to the fair value of the shares at the dates of grant. See Note I - "Stockholders' Equity" for further information on stock options.

### Benefit Plans

Prior to July 1, 2006, the Company maintained a defined contribution plan that combined a retirement plan and 401(k) plan. Effective that date, the Company's plan was merged with a similar plan sponsored by AFG. As a result, Company employees who meet the eligibility requirements participate in that plan. At the discretion of the GAFRI Board of Directors, GAFRI makes all contributions to the retirement fund portion of the Plan and matches a percentage of employee contributions to the savings fund. Employees are permitted to direct the investment of all contributions to independently managed investment securities as well as funds comprised of GAFRI and AFG securities. Company contributions are expensed in the year for which they are declared.

GAFRI and certain of its subsidiaries provide certain benefits to eligible retirees. The projected future cost of providing these benefits is expensed over the period the employees earn such benefits.

9

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### Earnings Per Share

Basic earnings per share is calculated using the weighted-average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes the following dilutive effect of common stock options: third quarter and first nine months of 2006 - 0.6 million shares each and

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

third quarter and first nine months of 2005 - 0.6 million shares and 0.4 million, respectively.

### Statement of Cash Flows

For cash flow purposes, "investing activities" are defined as making and collecting loans and acquiring and disposing of debt or equity instruments and property and equipment. "Financing activities" include annuity receipts, benefits and withdrawals and obtaining resources from owners and providing them with a return on their investments. All other activities are considered "operating." Short-term investments that have original maturities of three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

### C. Discontinued Operations

On June 2, 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for \$166 million. In accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets", the operating results and the gain on sale of the hotel are included in discontinued operations in the Consolidated Income Statement. GAFRI sold the Driskill Hotel in October 2005. The operating results of this hotel have been reclassified as discontinued operations to conform to the current year's presentation. Balance Sheet amounts prior to the hotel sales have not been reclassified. A summary of the hotel operations sold follows (in millions):

	Three months ended		Nine months ended	
Operations:	<u>September 30,</u>		<u>September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Real estate revenues	\$ -	\$16.9	\$3.9	\$33.4
Real estate expenses	<u>-</u>	<u>12.9</u>	<u>4.8</u>	<u>28.2</u>
Pre-tax earnings (loss)	-	4.0	(0.9)	5.2
Benefit (provision) for income taxes	<u>-</u>	<u>(1.3)</u>	<u>0.3</u>	<u>(1.7)</u>
		)	)	
Net earnings (loss) from discontinued hotel operations	<u>\$ -</u>	<u>\$ 2.7</u>	<u>(\$0.6)</u>	<u>\$ 3.5</u>



Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Included in real estate at December 31, 2005, was GAFRI's investment in Chatham Bars Inn of \$38.5 million. The Company recognized an after-tax gain on the sale of Chatham of approximately \$31.6 million (\$0.66 per diluted share).

In January 2006, GAFRI sold Great American Life Assurance Company of Puerto Rico ("GA-PR") for \$37.5 million in cash. In connection with the sale, a \$7.5 million letter of credit was established to provide for potential liabilities. Prior to the sale, in December 2005, GA-PR reinsured approximately two-thirds of its in-force business for \$60 million. During 2005, primarily in the fourth quarter, GA-PR paid dividends totaling \$100 million to GAFRI.

10

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

GA-PR's results are reflected as discontinued for all periods presented in the Consolidated Income Statement; Balance Sheet amounts prior to the sale have not been reclassified. The carrying amount of the major classes of GA-PR's assets and liabilities and a summary of the discontinued operations follow (in millions):

Assets:	<u>December 31, 2005</u>	
Cash and investments		\$207.7
Unamortized insurance acquisition costs ("DPAC")		21.8
Liabilities:		
Insurance reserves		\$181.0
Equity excluding unrealized gains		\$ 39.4
	Three months ended	Nine months ended
Operations:	<u>September 30, 2005</u>	<u>September 30, 2005</u>
Premiums	\$18.6	\$ 56.0
Investment income	2.8	8.8

Realized gains	0.1	4.8
Pre-tax earnings	\$ 2.9	\$ 14.0
Benefit for income taxes	<u>0.4</u>	<u>0.5</u>
Net earnings from discontinued operations	<u>\$ 3.3</u>	<u>\$ 14.5</u>

In January 2006, GAFRI recognized an additional pre-tax loss of \$0.5 million on the sale of GA-PR, offsetting a like amount of GA-PR earnings recorded prior to the sale.

#### D. Acquisitions

On August 7, 2006, GAFRI (parent) acquired all of the outstanding shares of Ceres Group, Inc. for approximately \$204 million in cash (excluding \$6.7 million of direct transaction costs), using cash on hand and borrowings under its bank line of credit. Prior to the acquisition, Ceres (through its two primary insurance subsidiaries, Continental General Insurance Company and Central Reserve Life Insurance Company) sold health and life insurance products through two primary business segments and had assets of approximately \$770 million at December 31, 2005. Its senior segment includes Medicare supplement and other senior health, life and annuity products for individuals age 55 and over. Its medical segment included major medical health insurance for individuals, families, associations and small businesses.

In connection with the acquisition, Ceres' insurance subsidiaries entered into a reinsurance agreement under which all of Ceres' medical business was ceded to an unaffiliated company. Immediately prior to the completion of the acquisition, half of Ceres' in-force senior business was ceded to an unaffiliated company. Ceres' insurance subsidiaries received pre-tax ceding commissions totaling \$64 million in connection with the reinsurance. Also prior to the acquisition, the insurance subsidiaries paid dividends totaling \$68 million to Ceres. Following the acquisition, Ceres distributed \$60 million to GAFRI. GAFRI used a portion of the distribution to repay all amounts borrowed under its bank line in connection with the acquisition. The operating results of Ceres are reflected in the accompanying financial statements since the date of acquisition.

GAFRI believes the acquisition of Ceres strengthens its Medicare Supplement operations by placing GAFRI in the top 10 in the U.S. in terms of Medicare Supplement premiums. In addition, GAFRI views this acquisition as (i) an effective use of its excess capital, (ii) a source of premium and earnings diversification, and (iii) a means of broadening its distribution capabilities through Ceres' captive agency force. GAFRI expects the retained Ceres business to generate about \$150 million in statutory premiums in 2007.

The acquisition has been accounted for using the purchase method of accounting in accordance with SFAS No. 141, "Business Combinations". The following table presents the preliminary allocations of the aggregate purchase price for the Ceres acquisition based on their estimated fair values. Such amounts are subject to change upon finalizing valuations.

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following table summarizes the estimated fair values of assets acquired and liabilities assumed at the date of acquisition (in millions):

Cash paid to Ceres shareholders	\$204.4
Direct acquisition costs (paid by Ceres)	<u>6.7</u>
Total purchase price (including costs paid by Ceres)	<u>\$211.1</u>
Allocation of purchase price:	
Cash and investments	\$350.8
Present value of future profits acquired ("PVFP")	53.5
Reinsurance recoverable	409.9
Goodwill	11.9
Other assets	32.0
Insurance liabilities	(603.0)
Other liabilities	<u>(44.0)</u>
	)
Total purchase price (including costs paid by Ceres)	<u>\$211.1</u>

Pro forma results of operations for the three and nine months ended September 30, 2006, assuming the acquisition of Ceres had taken place at the beginning of 2006, would not differ significantly from actual reported results.

In January 2006, GALIC acquired, through a reinsurance transaction, the fixed annuity block written by Old Standard Life Insurance Company. As part of the assets received in the reinsurance transaction, GALIC also acquired the stock of Old West Annuity and Life Insurance Company. In total, the transaction resulted in an increase of approximately \$280 million in both annuity benefits accumulated and cash and investments, including a payment (negative ceding commission) from the seller of approximately \$9 million.

E. Segments of Operations

GAFRI manages its business as four segments: (i) annuity operations; (ii) supplemental insurance; (iii) life operations; and (iv) corporate and other, which include holding company assets and costs as well as interest and other debt expenses.

Revenue from GAFRI's annuity operations consists primarily of investment income as well as operating revenues from its real estate investments. GAFRI's annuity products are sold through independent agents to employees of primary and secondary educational institutions and in the non-qualified markets. GAFRI is engaged in a variety of real estate operations including hotels and marinas.

GAFRI's supplemental insurance businesses (United Teacher Associates Insurance Company ("UTA"), Loyal American Life Insurance Company, Continental General Insurance Company and Central Reserve Life Insurance Company) primarily offer a variety of Medicare Supplement and limited benefit policies to supplement primary health insurance and other insurance coverage. These products are offered primarily through independent agents.

Traditional term and universal life insurance products had been marketed through national marketing organizations. In 2004, GAFRI suspended new sales of these life insurance products due to inadequate volume and returns. The Company continues to service its in-force block of these policies.

"Corporate and other" consists primarily of GAFRI (parent) and AAG Holding (intermediate holding company) and includes interest expense.

12

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following table shows (in millions) GAFRI's revenues and operating profit by significant business segment.

	Three months ended		Nine months ended	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
<u>Revenues</u>				
Fixed annuity operations	\$131.4	\$120.9	\$393.6	\$368.9
Variable annuity operations	5.7	5.7	17.6	17.2
Real estate operations	<u>9.7</u>	<u>7.2</u>	<u>27.4</u>	<u>20.3</u>

(1)

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Total annuity operations	146.8	133.8	438.6	406.4
Supplemental insurance operations	107.1	77.0	266.0	227.6
Life operations	17.5	18.8	54.2	57.3
Corporate and other	<u>3.4</u>	<u>3.0</u>	<u>11.9</u>	<u>7.9</u>
Total operating revenues	274.8	232.6	770.7	699.2
Realized gains (losses)	<u>(3.0)</u>	<u>3.4</u>	<u>(11.9)</u>	<u>4.9</u>
	)	)		
Total revenues per income statement	<u>\$271.8</u>	<u>\$236.0</u>	<u>\$758.8</u>	<u>\$704.1</u>
<u>Operating profit - pre-tax</u>				
Fixed annuity operations	\$ 23.7	\$ 23.6	\$ 77.2	\$ 69.7
Variable annuity operations	0.7	0.6	2.1	2.0
Real estate operations:				
Operating cash flow	2.7	1.8	5.5	6.4
Depreciation and other	<u>(1.5)</u>	<u>(1.2)</u>	<u>1.4</u>	<u>(4.3)</u>
	)	)	(1)	)
Total annuity operations	25.6	24.8	86.2	73.8
Supplemental insurance operations	12.7(2)	6.6	16.9	20.4
Life operations	1.9	1.7	6.0	1.3
Corporate and other:				
Interest and other debt expenses	(5.6)	(7.1)	(17.5)	(20.9)
Other	<u>(1.1)</u>	<u>(9.6)</u>	<u>(1.3)</u>	<u>(11.6)</u>
	)	)	(3)	)
Pre-tax earnings from continuing operations	33.5	16.4	90.3	63.0
Realized gains (losses)	<u>(3.0)</u>	<u>3.4</u>	<u>(11.9)</u>	<u>4.9</u>
	)	)		
Total operating earnings before income taxes per income statement	<u>\$ 30.5</u>	<u>\$ 19.8</u>	<u>\$ 78.4</u>	<u>\$ 67.9</u>

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

1. Year-to-date 2006 amount includes \$4.9 million of income resulting from a March 2006 payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company.
2. Includes \$3.4 million reduction in Medicare supplement IBNR reserves due to favorable claim development in that line of business.
3. Includes pre-tax charge of \$9.5 million related to environmental liabilities at the Company's former manufacturing operations.

### F. Mortgage Loans on Real Estate

Included in mortgage loans at September 30, 2006 is an \$86 million mortgage loan issued in connection with the sale of Chatham Bars Inn.

13

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

### G. Unamortized Insurance Acquisition Costs

Unamortized insurance acquisition costs consisted of the following (in millions):

	September 30, <u>2006</u>	December 31, <u>2005</u>
Deferred policy acquisition costs ("DPAC")	\$718.0	\$726.1
Sales inducements	87.1	73.0
Unrealized DPAC adjustment*	1.4	(17.3)
PVFP	<u>94.4</u>	<u>54.1</u>
	<u>\$900.9</u>	<u>\$835.9</u>

---

\*Reflects the change in DPAC assuming the unrealized gains or losses on securities had actually been realized. See Note B - "Accounting Policies."

The decrease in DPAC reflects the January 2006 sale of GA-PR. The increase in PVFP reflects the acquisition of Ceres, partially offset by the sale of GA-PR. The PVFP amounts in the table above are net of \$67.5 million and \$82.5 million of accumulated amortization at September 30, 2006 and December 31, 2005, respectively. Amortization of the PVFP was \$2.8 million in the third quarter of 2006 and \$6.0 million in the first nine months of 2006 compared to \$1.3 million in the third quarter of 2005 and \$6.4 million in the first nine months of 2005.

### H. Long-Term Debt

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Long-term debt consisted of the following (in millions):

	September 30, <u>2006</u>	December 31, <u>2005</u>
Direct obligations of GAFRI	\$ 0.8	\$ 1.0
Obligations of AAG Holding (guaranteed by GAFRI):		
7-1/2% Senior Debentures due 2033	112.5	112.5
6-7/8% Senior Notes due 2008	33.6	100.0
7-1/4% Senior Debentures due 2034	<u>86.3</u>	<u>86.3</u>
	<u>233.2</u>	<u>299.8</u>
Payable to Subsidiary Trusts:		
AAG Holding 8-7/8% Subordinated Debentures due 2027	22.0	22.0
AAG Holding 7.35% Subordinated Debentures due 2033	<u>20.0</u>	<u>20.0</u>
	<u>42.0</u>	<u>42.0</u>
	<u>\$275.2</u>	<u>\$341.8</u>

To achieve a desired balance between fixed and variable rate debt, GAFRI entered into interest rate swaps which effectively convert its 6-7/8% Senior Notes to a floating rate of 3-month LIBOR plus 2.9% (effective rate of approximately 8.3% and 7.4% at September 30, 2006 and December 31, 2005, respectively).

In the first nine months of 2006, GAFRI repurchased \$66.4 million principal amount of its 6-7/8% Senior Notes for \$68.7 million in cash. In connection with the repurchase, GAFRI paid an additional \$2.0 million to effectively terminate the portion of the interest rate swap that covered the repurchased debt; the cost to terminate the portion of the swap is included in the loss on retirement of debt in the Consolidated Income Statement.

In March 2006, the Company replaced its existing \$165 million bank credit agreement with a new \$500 million five-year revolving credit facility shared with AFG. Under terms of the new agreement, GAFRI may borrow up to \$175 million with the ability to borrow up to \$200 million, conditioned on AFG not borrowing in excess of \$300 million. AFG has agreed with GAFRI not to borrow more than \$325 million under the credit facility and has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. No amounts were borrowed

under these agreements at September 30, 2006 or December 31, 2005.

14

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

At September 30, 2006, GAFRI had virtually no scheduled principal payments on debt for the next five years other than AAG Holding's Senior Notes due in 2008.

I. Stockholders' Equity

At September 30, 2006, there were 6.5 million shares of GAFRI Common Stock reserved for issuance under GAFRI's stock option plans. As of that date, options for 3.7 million shares were outstanding. Under these plans, the exercise price of each option equals the market price of GAFRI Common Stock at the date of grant. Options generally become exercisable at the rate of 20% per year commencing one year after grant. Options generally expire ten years after the date of grant. In the first nine months of 2006, 284,503 shares of Common Stock were issued upon the exercise of stock options. In connection with certain of these exercises, 30,653 shares were delivered as payment of the exercise price and these shares were retired. Data for stock options issued under GAFRI's stock option plans is presented below:

	<u>Shares</u>	<u>Average Exercise Price</u>	<u>Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value (in millions)</u>
Outstanding at January 1, 2006	3,351,755	\$17.12		
Granted	683,533	\$19.42		
Exercised	(284,503)	\$15.03		
Forfeited/Cancelled	<u>(90,425)</u>	\$19.33		
)				
Outstanding at September 30, 2006	<u>3,660,360</u>	\$17.66	5.9 years	\$12.7
Options exercisable September 30, 2006	<u>2,218,000</u>	\$17.87	4.5 years	\$7.5



Options available for grant at  
September 30, 2006 2,879,046

The total intrinsic value of options exercised during the first nine months of 2006 and 2005 was \$1.5 million and \$2.6 million, respectively. During the first nine months of 2006, GAFRI received \$3.6 million from the exercise of stock options. The total tax benefit realized from the exercises was \$0.4 million.

GAFRI uses the Black-Scholes option-pricing model to calculate the fair value of its option grants. Expected volatility is based on historical volatility (after consideration of other factors). Beginning with grants made in 2006, GAFRI calculates historical volatility using daily prices. GAFRI began using the SEC's simplified method of calculating expected term with its 2006 grants. The fair value of options granted in the first nine months of 2006 and 2005 was \$6.50 per share and \$5.24 per share, respectively, based on the following assumptions: dividend yield of less than 1%; expected volatility of 20%; risk-free interest rate of 4.6% in 2006 and 4.3% in 2005; and expected option life of 6.5 years for 2006 and 7.5 years for 2005.

GAFRI's total stock compensation expense for the third quarter and first nine months of 2006 was \$0.6 million and \$1.7 million, respectively. Related tax benefits totaled \$0.1 million for the third quarter and \$0.3 million for the nine months. As of September 30, 2006, there was a total of \$6.2 million of total unrecognized compensation expense related to nonvested stock options granted under GAFRI's plan. That cost is expected to be recognized over a weighted average of 3.5 years.

15

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following table illustrates the effect on net income (in millions) and earnings per share, had compensation cost been recognized and determined based on the "fair values" at grant dates consistent with the method used beginning in 2006.

	<u>Three months ended September 30, 2005</u>	<u>Nine months ended September 30, 2005</u>
Net income, as reported	\$18.8	\$62.3
Pro forma stock option expense, net of tax	<u>(0.4)</u>	<u>(1.2)</u>
	)	)

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Adjusted net income	<u>\$18.4</u>	<u>\$61.1</u>
---------------------	---------------	---------------

Earnings per share (as reported):

Basic	\$0.40	\$1.32
Diluted	\$0.39	\$1.31

Earnings per share (adjusted):

Basic	\$0.39	\$1.30
Diluted	\$0.38	\$1.29

The Company is authorized to issue 25,000,000 shares of Preferred Stock, par value \$1.00 per share.

J. Contingencies

There have been no significant changes to the matters discussed and referred to in Note N - "Contingencies" of GAFRI's Annual Report on Form 10-K for 2005.

K. Additional Information

Statutory Information

Insurance companies are required to file financial statements with state insurance regulatory authorities prepared on an accounting basis prescribed or permitted by such authorities (statutory basis). Certain statutory amounts for GALIC, GAFRI's primary insurance subsidiary, were as follows (in millions):

	September 30, <u>2006</u>	December 31, <u>2005</u>
Capital and surplus	\$606.3	\$638.0
Asset valuation reserve	86.3	84.6
Interest maintenance reserve	-	10.1

Nine months ended September 30

	<u>2006</u>	<u>2005</u>
Pre-tax income from operations	\$ 65.1	\$82.5
Net income	109.3	62.0

The maximum amount of dividends payable by GALIC in 2006 without prior regulatory approval is \$148 million. In the first nine months of 2006, GALIC paid \$147.7 million in dividends to GAFRI.

#### Variable Annuities

At September 30, 2006, the aggregate guaranteed minimum death benefit value (assuming every policyholder died) on all of GAFRI's variable annuity policies exceeded the fair value of the underlying variable annuities by \$72 million compared to \$83 million at December 31, 2005. Death benefits paid in excess of the variable annuity account balances were \$0.3 million and \$0.6 million in the first nine months of 2006 and 2005, respectively.

16

### GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### Condensed Consolidating Information

GAFRI has guaranteed all of the outstanding debt of AAG Holding. Condensed (unaudited) consolidating financial statements for GAFRI are as follows:

#### CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

<u>SEPTEMBER 30, 2006</u>	<u>GAFRI</u>	<u>AAG HOLDING</u>	<u>ALL OTHER SUBS</u>	<u>CONS ENTRIES</u>	<u>CONS</u>
<b>Assets</b>					
Cash and investments	\$ 33.2	\$ -	\$10,430.1	(\$ 0.1)	\$10,463.2
Investment in subsidiaries	968.8	1,219.5	24.2	(2,212.5)	-
Notes receivable from subs	102.4	-	-	(102.4)	-
Unamortized insurance acquisition costs	-	-	900.9	-	900.9
Other assets	24.6	7.5	884.1	38.8	955.0

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Variable annuity assets (separate accounts)	<u>-</u>	<u>-</u>	<u>663.5</u>	<u>-</u>	<u>663.5</u>
	<u>\$1,129.0</u>	<u>\$1,227.0</u>	<u>\$12,902.8</u>	<u>(\$2,276.2)</u>	<u>\$12,982.6</u>
Liabilities and Stockholders' Equity					
Insurance liabilities	\$ -	\$ -	\$10,688.1	(\$ 5.1)	\$10,683.0
Notes payable to GAFRI	-	102.4	-	(102.4)	-
Other long-term debt	0.9	396.7	-	(122.4)	275.2
Other liabilities	82.8	11.4	230.6	(9.2)	315.6
Variable annuity liabilities (separate accounts)	<u>-</u>	<u>-</u>	<u>663.5</u>	<u>-</u>	<u>663.5</u>
	83.7	510.5	11,582.2	(239.1)	11,937.3
Total stockholders' equity	<u>1,045.3</u>	<u>716.5</u>	<u>1,320.6</u>	<u>(2,037.1)</u>	<u>1,045.3</u>
	<u>\$1,129.0</u>	<u>\$1,227.0</u>	<u>\$12,902.8</u>	<u>(\$2,276.2)</u>	<u>\$12,982.6</u>

DECEMBER 31, 2005

Assets					
Cash and investments	\$ 64.6	\$ 0.3	\$ 9,898.2	\$ -	\$ 9,963.1
Investment in subsidiaries	894.2	1,312.8	24.8	(2,231.8)	-
Notes receivable from subs	104.3	-	-	(104.3)	-
Unamortized insurance acquisition costs	-	-	835.9	-	835.9
Other assets	23.4	7.3	405.1	43.7	479.5
Variable annuity assets (separate accounts)	<u>-</u>	<u>-</u>	<u>643.5</u>	<u>-</u>	<u>643.5</u>
	<u>\$1,086.5</u>	<u>\$1,320.4</u>	<u>\$11,807.5</u>	<u>(\$2,292.4)</u>	<u>\$11,922.0</u>

Liabilities and Stockholders' Equity

Insurance liabilities	\$ -	\$ -	\$ 9,628.4	(\$ 4.9)	\$ 9,623.5
Notes payable to GAFRI	-	102.4	1.9	(104.3)	-
Other long-term debt	1.0	396.7	-	(55.9)	341.8
Other liabilities	78.8	7.6	222.9	(2.8)	306.5
Variable annuity liabilities (separate accounts)	<u>-</u>	<u>-</u>	<u>643.5</u>	<u>-</u>	<u>643.5</u>
	79.8	506.7	10,496.7	(167.9)	10,915.3
Total stockholders' equity	<u>1,006.7</u>	<u>813.7</u>	<u>1,310.8</u>	<u>(2,124.5)</u>	<u>1,006.7</u>
			)		
	<u>\$1,086.5</u>	<u>\$1,320.4</u>	<u>\$11,807.5</u>	<u>(\$2,292.4)</u>	<u>\$11,922.0</u>

17

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

FOR THE THREE MONTHS ENDED	AAG		ALL	CONS	
			OTHER		
<u>SEPTEMBER 30, 2006</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>

Revenues

:					
Life, accident and health premiums	\$ -	\$ -	\$ 91.7	\$ -	\$ 91.7
Net investment income and other revenue	8.1	(0.1)	176.9	(4.8)	180.1
Equity in earnings of subsidiaries	<u>25.0</u>	<u>34.5</u>	<u>-</u>	<u>(59.5)</u>	<u>-</u>
			)		
	33.1	34.4	268.6	(64.3)	271.8

Costs and Expenses:

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Insurance benefits and expenses	-	-	195.7	-	195.7
Interest and debt expenses	0.1	10.3	-	(4.8)	5.6
Other expenses	<u>2.5</u>	<u>2.3</u>	<u>35.2</u>	<u>-</u>	<u>40.0</u>
	<u>2.6</u>	<u>12.6</u>	<u>230.9</u>	<u>(4.8)</u>	<u>241.3</u>
			)		
Earnings before income taxes	30.5	21.8	37.7	(59.5)	30.5
Provision for income taxes	<u>10.7</u>	<u>7.6</u>	<u>13.2</u>	<u>(20.8)</u>	<u>10.7</u>
			)		
Net income	<u>\$19.8</u>	<u>\$14.2</u>	<u>\$ 24.5</u>	<u>(\$ 38.7)</u>	<u>\$ 19.8</u>

FOR THE NINE MONTHS ENDED  
SEPTEMBER 30, 2006

Revenues

:					
Life, accident and health premiums	\$ -	\$ -	\$243.7	\$ -	\$243.7
Net investment income and other revenue	21.2	(2.2)	509.6	(13.5)	515.1
Equity in earnings of subsidiaries	<u>64.8</u>	<u>148.1</u>	<u>-</u>	<u>(212.9)</u>	<u>-</u>
			)		
	86.0	145.9	753.3	(226.4)	758.8

Costs and Expenses:

Insurance benefits and expenses	-	-	555.7	-	555.7
Interest and debt expenses	0.1	31.0	-	(13.6)	17.5
Other expenses	<u>7.5</u>	<u>6.6</u>	<u>93.1</u>	<u>-</u>	<u>107.2</u>
	<u>7.6</u>	<u>37.6</u>	<u>648.8</u>	<u>(13.6)</u>	<u>680.4</u>
			)		
Earnings before income taxes	78.4	108.3	104.5	(212.8)	78.4
Provision for income taxes	<u>27.4</u>	<u>38.0</u>	<u>36.6</u>	<u>(74.6)</u>	<u>27.4</u>

				)	
Income from continuing operations	51.0	70.3	67.9	(138.2)	51.0
Discontinued hotel operations, net of tax	(0.6)	-	(0.6)	0.6	(0.6)
Gain on sale of discontinued hotel, net of tax	<u>31.6</u>	<u>-</u>	<u>31.6</u>	<u>(31.6)</u>	<u>31.6</u>
				)	
Net income	<u>\$82.0</u>	<u>\$70.3</u>	<u>\$ 98.9</u>	<u>(\$169.2)</u>	<u>\$ 82.0</u>

18

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued  
 CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

FOR THE THREE MONTHS ENDED	AAG		ALL OTHER	CONS	
<u>SEPTEMBER 30, 2005</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>
Revenues					
:					
Life, accident and health premiums	\$ -	\$ -	\$ 73.2	\$ -	\$ 73.2
Net investment income and other revenue	5.3	-	160.5	(3.0)	162.8
Equity in earnings of subsidiaries	<u>26.0</u>	<u>41.5</u>	<u>-</u>	<u>(67.5)</u>	<u>-</u>
				)	
	31.3	41.5	233.7	(70.5)	236.0
Costs and Expenses:					
Insurance benefits and expenses	-	-	170.2	-	170.2
Interest and debt expenses	0.1	10.3	-	(3.3)	7.1
Other expenses	<u>11.4</u>	<u>1.5</u>	<u>26.0</u>	<u>-</u>	<u>38.9</u>

	<u>11.5</u>	<u>11.8</u>	<u>196.2</u>	<u>(3.3)</u>	<u>216.2</u>
				)	
Earnings before income taxes	19.8	29.7	37.5	(67.2)	19.8
Provision for income taxes	<u>7.0</u>	<u>10.3</u>	<u>13.0</u>	<u>(23.3)</u>	<u>7.0</u>
				)	
Income from continuing operations	12.8	19.4	24.5	(43.9)	12.8
Discontinued Puerto Rican operations, net	3.3	-	3.3	(3.3)	3.3
Discontinued hotel operations, net of tax	<u>2.7</u>	<u>-</u>	<u>2.7</u>	<u>(2.7)</u>	<u>2.7</u>
				)	
Net income	<u>\$18.8</u>	<u>\$ 19.4</u>	<u>\$ 30.5</u>	<u>(\$ 49.9)</u>	<u>\$ 18.8</u>

FOR THE NINE MONTHS ENDED  
SEPTEMBER 30, 2005

Revenues

:					
Life, accident and health premiums	\$ -	\$ -	\$220.3	\$ -	\$220.3
Net investment income and other revenue	15.4	-	477.5	(9.1)	483.8
Equity in earnings of subsidiaries	<u>68.5</u>	<u>107.8</u>	<u>-</u>	<u>(176.3)</u>	<u>-</u>
				)	
	83.9	107.8	697.8	(185.4)	704.1
Costs and Expenses:					
Insurance benefits and expenses	-	-	512.0	-	512.0
Interest and debt expenses	0.1	30.5	-	(9.7)	20.9
Other expenses	<u>15.9</u>	<u>4.5</u>	<u>82.9</u>	<u>-</u>	<u>103.3</u>
	<u>16.0</u>	<u>35.0</u>	<u>594.9</u>	<u>(9.7)</u>	<u>636.2</u>
				)	



Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Earnings before income taxes	67.9	72.8	102.9	(175.7)	67.9
Provision for income taxes	<u>23.6</u>	<u>25.2</u>	<u>35.4</u>	<u>(60.6)</u>	<u>23.6</u>
				)	
Income from continuing operations	44.3	47.6	67.5	(115.1)	44.3
Discontinued Puerto Rican operations, net	14.5	-	14.5	(14.5)	14.5
Discontinued hotel operations, net of tax	<u>3.5</u>	<u>-</u>	<u>3.5</u>	<u>(3.5)</u>	<u>3.5</u>
				)	
Net income	<u>\$62.3</u>	<u>\$ 47.6</u>	<u>\$ 85.5</u>	<u>(\$133.1)</u>	<u>\$ 62.3</u>

19

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued  
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

FOR THE NINE MONTHS ENDED	AAG		ALL	CONS	
	GAFRI	HOLDING	OTHER	ENTRIES	CONS
<u>SEPTEMBER 30, 2006</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>
Cash Flows from Operating Activities:					
Net income	\$ 82.0	\$ 70.3	\$ 98.9	(\$169.2)	\$ 82.0
Adjustments:					
Equity in net earnings of subsidiaries and affiliates	(73.5)	(96.3)	-	169.8	-
Increase in life, accident and health reserves	-	-	15.4	-	15.4
Benefits to annuity policyholders	-	-	255.1	-	255.1
Amortization of insurance acquisition costs	-	-	76.1	-	76.1

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Depreciation and amortization	2.9	1.3	5.4	-	9.6
Realized losses on investments	1.4	-	5.7	0.3	7.4
Gain on sale of discontinued hotel	-	-	(48.7)	-	(48.7)
Realized loss on retirement of debt	2.2	2.2	-	-	4.4
Net trading portfolio activity	-	-	(10.8)	-	(10.8)
Increase in insurance acquisition costs	-	-	(114.6)	-	(114.6)
Increase in reinsurance recoverable	-	-	(47.6)	-	(47.6)
Decrease (increase) in other assets	(0.4)	(0.2)	9.3	-	8.7
Increase (decrease) in other liabilities	0.7	6.1	(5.6)	-	1.2
Increase (decrease) in payable to affiliates, net	6.1	(2.3)	(6.8)	-	(3.0)
Capital contribution from parent (to subsidiary)	(92.6)	92.6	-	-	-
Dividends from subsidiaries(to parent)	271.7	(63.7)	(208.0)	-	-
Other, net	<u>(0.4)</u>	<u>(8.4)</u>	<u>13.4</u>	<u>(0.9)</u>	<u>3.7</u>
	)	)	)		
	<u>200.1</u>	<u>1.6</u>	<u>37.2</u>	<u>-</u>	<u>238.9</u>

Cash Flows from Investing Activities:

Purchases of investments and other assets	-	-	(1,379.2)	-	(1,379.2)
Purchase of subsidiary	(204.4)	-	-	-	(204.4)
Proceeds received from sale of Puerto Rican operations, net	37.5	-	(10.3)	-	27.2
Maturities and redemptions of fixed maturity investments	1.2	-	361.0	-	362.2
Cash and short-term investments of businesses acquired, net	-	-	217.8	-	217.8
Sales of investments and other assets	37.0	-	1,112.7	-	1,149.7
Increase in policy loans	<u>-</u>	<u>-</u>	<u>(7.8)</u>	<u>-</u>	<u>(7.8)</u>
	)	)	)		
	<u>(128.7)</u>	<u>-</u>	<u>294.2</u>	<u>-</u>	<u>165.5</u>

Cash Flows from Financing Activities:

Fixed annuity receipts	-	-	914.3	-	914.3
Annuity surrenders, benefits and withdrawals	-	-	(898.6)	-	(898.6)
Net transfers from variable annuity assets	-	-	17.8	-	17.8
Additions to long-term debt	-	65.0	-	-	65.0

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Reductions of long-term debt	(68.9)	(66.9)	(5.5)	-	(141.3)
Issuance of Common Stock	4.0	-	-	-	4.0
Retirement of Common Stock	<u>(0.9)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(0.9)</u>
	)			)	
	<u>(65.8)</u>	<u>(1.9)</u>	<u>28.0</u>	<u>-</u>	<u>(39.7)</u>
	)	)		)	
Net increase in cash and short-term investments	5.6	(0.3)	359.4	-	364.7
Beginning cash and short-term investments	<u>7.9</u>	<u>0.3</u>	<u>146.1</u>	<u>-</u>	<u>154.3</u>
Ending cash and short-term investments	<u>\$ 13.5</u>	<u>\$ -</u>	<u>\$ 505.5</u>	<u>\$ -</u>	<u>\$ 519.0</u>

20

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued  
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

FOR THE NINE MONTHS ENDED	AAG	ALL	CONS		
		OTHER	ENTRIES		
<u>SEPTEMBER 30, 2005</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>
Cash Flows from Operating Activities:					
Net income	\$62.3	\$47.6	\$ 85.5	(\$133.1)	\$ 62.3
Adjustments:					
Equity in net earnings of subsidiaries and affiliates	(62.7)	(70.7)	-	133.4	-
Increase in life, accident and health reserves	-	-	50.0	-	50.0
Benefits to annuity policyholders	-	-	246.5	-	246.5
Amortization of insurance acquisition costs	-	-	77.2	-	77.2

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Depreciation and amortization	-	1.5	23.1	-	24.6
Realized gains on investments	-	-	(9.7)	-	(9.7)
Net trading portfolio activity	-	-	11.7	-	11.7
Increase in insurance acquisition costs	-	-	(94.0)	-	(94.0)
Decrease in reinsurance recoverable	-	-	0.9	-	0.9
Decrease (increase) in other assets	(3.3)	0.6	6.6	-	3.9
Increase in other liabilities	4.4	3.8	2.8	-	11.0
Increase (decrease) in payable to affiliates, net	3.1	(0.9)	15.1	-	17.3
Capital contribution from parent (to subsidiary)	(63.6)	48.6	15.0	-	-
Dividends from subsidiaries(to parent)	74.4	(29.4)	(45.0)	-	-
Other, net	<u>0.9</u>	<u>(0.4)</u>	<u>(0.7)</u>	<u>(0.3)</u>	<u>(0.5)</u>
	)	)	)	)	
	<u>15.5</u>	<u>0.7</u>	<u>385.0</u>	<u>-</u>	<u>401.2</u>

Cash Flows from Investing Activities:

Purchases of investments and other assets	-	-	(1,707.1)	-	(1,707.1)
Maturities and redemptions of fixed maturity investments	-	-	518.9	-	518.9
Sales of investments and other assets	-	-	841.7	-	841.7
Increase in policy loans	<u>-</u>	<u>-</u>	<u>(5.4)</u>	<u>-</u>	<u>(5.4)</u>
		)		)	
	<u>-</u>	<u>-</u>	<u>(351.9)</u>	<u>-</u>	<u>(351.9)</u>
		)		)	

Cash Flows from Financing Activities:

Fixed annuity receipts	-	-	632.5	-	632.5
Annuity surrenders, benefits and withdrawals	-	-	(688.4)	-	(688.4)
Net transfers from variable annuity assets	-	-	10.1	-	10.1
Reductions of notes payable	(0.1)	-	-	-	(0.1)
Issuance of Common Stock	1.9	-	-	-	1.9
Retirement of Common Stock	<u>(2.5)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(2.5)</u>
	)	)	)	)	
	<u>(0.7)</u>	<u>-</u>	<u>(45.8)</u>	<u>-</u>	<u>(46.5)</u>
	)	)	)	)	

Net increase in cash and short-term investments	14.8	0.7	(12.7)	-	2.8
Beginning cash and short-term investments	<u>1.0</u>	<u>-</u>	<u>169.2</u>	<u>-</u>	<u>170.2</u>
Ending cash and short-term investments	<u>\$15.8</u>	<u>\$ 0.7</u>	<u>\$156.5</u>	<u>\$ -</u>	<u>\$173.0</u>

21

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

ITEM 2

Management's Discussion and Analysis

of Financial Condition and Results of Operations

Index to MD&A

	<u>Page</u>		<u>Page</u>
Forward-Looking Statements	22	Results of Operations	28
General	22	General	28
Overview	23	Income Items	29
Critical Accounting Policies	23	Expense Items	31
Liquidity and Capital Resources	24		
Ratios	24		
Sources and Uses of Funds	24		
Independent Ratings	25		
Investments	26		

## FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words such as "anticipates", "believes", "expects", "estimates", "intends", "plans", "seeks", "could", "may", "should", "will" or the negative version of those words or other comparable terminology. Such forward-looking statements relate to: expectations concerning market and other conditions and their effect on future premiums, revenues, earning and investment activities; recoverability of asset values; mortality and the adequacy of reserves for environmental pollution.

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;
- trends in persistency, mortality and morbidity;
- regulatory actions;
- changes in regulatory and legal environments;
- tax law changes;
- changes in laws governing retirement savings vehicles;
- cost of environmental clean-up at former manufacturing sites operated by the Company's predecessor;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- acquisitions;
- competitive pressures; and
- changes in debt and claims paying ratings.

Forward-looking statements included in this Form 10-Q are made only as of the date of this report and under Section 27A of the Securities Act and Section 21E of the Exchange Act of 1934; we do not have any obligation to update any forward-looking statement to reflect subsequent events or circumstances.

## GENERAL

Great American Financial Resources, Inc. ("GAFRI" or "the Company") and its subsidiary, AAG Holding Company, Inc., are organized as holding companies with nearly all of their operations being conducted by their subsidiaries. These companies, however, have continuing expenditures for administrative expenses, corporate services and for the payment of interest and principal on borrowings and stockholder dividends.

22

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

### of Financial Condition and Results of Operations - Continued

## OVERVIEW

### Financial Condition

Over the last several years, GAFRI has significantly strengthened its capital and liquidity. Since December 31, 2002, stockholders' equity (excluding unrealized gains and losses on fixed maturities) has grown more than \$348 million (51%) to \$1.0 billion and its debt to total capital decreased from more than 36% to 21%; in addition, the adjusted

capital of GAFRI's largest insurance subsidiary increased nearly \$220 million (45%) to \$704 million.

## Results of Operations

Through the operations of its insurance subsidiaries, GAFRI is engaged in the sale of retirement annuities and various forms of Medicare supplement and other supplemental insurance products.

GAFRI's net income for the third quarter of 2006 was \$19.8 million (\$0.41 per diluted share) compared to \$18.8 million (\$0.39 per diluted share) for the same period in 2005. The increase reflects improved results in each of the Company's lines of business, including results of acquisitions and a \$3.4 million reduction of supplemental insurance IBNR reserves in the Medicare supplement business of GAFRI's subsidiary, United Teacher Associates ("UTA"); in addition, 2005 net income included a third quarter environmental charge of \$9.5 million relating to the Company's former manufacturing operations. These items were partially offset by realized investment losses in 2006 compared to gains in 2005, and the impact of selling Great American Life Assurance Company of Puerto Rico ("GA-PR") in January 2006 and Chatham Bars Inn in June 2006 (See Note C - "Discontinued Operations").

GAFRI's net income for the first nine months of 2006 was \$82.0 million (\$1.71 per diluted share), compared to \$62.3 million (\$1.31 per diluted share) for the same period in 2005. The improvements in 2006 reflect (i) a \$31.6 million after-tax gain on the sale of Chatham; (ii) improvements in GAFRI's fixed annuity operations resulting primarily from the January 2006 acquisition of an annuity block of business and higher real estate income; and (iii) higher earnings in GAFRI's runoff life operations resulting from an improvement in mortality experience and lower expenses. As mentioned above, results for 2005 reflected a third quarter environmental charge of \$9.5 million relating to the Company's former manufacturing operations. These items were partially offset by (i) a decrease in supplemental insurance operations earnings in the first half of 2006, which resulted from the effects of lower first year premiums, higher lapses and higher loss experience at UTA; (ii) realized investment losses in 2006 compared to gains in 2005, (iii) loss on the retirement of debt; and (iv) the impact of selling GA-PR in January 2006 and Chatham in June 2006.

## CRITICAL ACCOUNTING POLICIES

Significant accounting policies are described in Note B to the financial statements. The preparation of financial statements requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future.

Management believes that the following items are the areas where the degree of judgment required in determining amounts recorded in the financial statements make the accounting policies critical:

- The recoverability of unamortized insurance acquisition costs;
- The establishment of insurance reserves;
- The determination of "other than temporary" impairments on investments; and
- Environmental reserves with respect to GAFRI's former manufacturing operations.

For further discussion of these policies, see "Critical Accounting Policies" in GAFRI's 2005 Form 10-K.

of Financial Condition and Results of Operations - Continued

## LIQUIDITY AND CAPITAL RESOURCES

## Ratios

GAFRI's consolidated debt to capital ratio is shown below (dollars in millions). For purposes of this calculation, capital represents the sum of consolidated debt and stockholders' equity (excluding unrealized gains and losses on fixed maturity securities).

	September 30,	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Consolidated Debt	\$ 275	\$ 342	\$ 363
Stockholders' Equity	<u>1,038</u>	<u>949</u>	<u>895</u>
Total Capital	<u>\$1,313</u>	<u>\$1,291</u>	<u>\$1,258</u>
Consolidated Debt to Capital	21.0%	26.5%	28.9%

The National Association of Insurance Commissioners' ("NAIC") risk-based capital ("RBC") formula determines the amount of capital that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. At September 30, 2006, the capital ratio of GAFRI's principal insurance subsidiary was 6.6 times its authorized control level RBC.

Sources and Uses of Funds

## Parent Holding Company Liquidity

To pay interest and principal on borrowings and other holding company costs, GAFRI (parent) and AAG Holding use primarily capital distributions from Great American Life Insurance Company ("GALIC"), bank borrowings and cash and investments on hand. Capital distributions from GAFRI's insurance subsidiaries are subject to regulatory restrictions relating to statutory surplus and earnings. The maximum amount of dividends payable by GALIC in 2006 without prior regulatory approval is \$148 million. In the first nine months of 2006, GALIC paid \$147.7 million in dividends to GAFRI.

In March 2006, the Company replaced its existing credit agreement with a new \$500 million five-year credit facility shared with its parent company American Financial Group, Inc. Under terms of the new agreement, GAFRI may borrow up to \$175 million with the ability to borrow up to \$200 million, conditioned on AFG not borrowing in excess of \$300 million. No amounts were outstanding under this agreement at September 30, 2006. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating; GAFRI's current rate would



be 0.6% over LIBOR. Under a currently effective shelf registration, GAFRI and AAG Holding can issue up to \$250 million in additional equity or debt securities.

On August 7, 2006, GAFRI (parent) acquired all of the outstanding shares of Ceres Group Inc. for \$204.4 million in cash. To fund the acquisition, GAFRI used cash on hand and borrowings under its bank line. Following the acquisition, Ceres distributed \$60 million to GAFRI. GAFRI used a portion of the distribution to repay all amounts borrowed under its bank line in connection with the acquisition.

GAFRI believes that it has sufficient resources to meet its liquidity requirements.

#### Subsidiary Liquidity

The liquidity requirements of GAFRI's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, and the payments of dividends and taxes to GAFRI. Historically, cash flows from maturities of bonds held in the investment portfolio, premiums and investment income have exceeded the funds needed to meet these requirements without forcing the sale of investments or requiring contributions from GAFRI. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold an adequate amount of highly liquid, short-term investments.

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

24

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

totaled approximately \$221 million and \$643 million in the third quarter and first nine months of 2006 compared to \$160 million and \$452 million in the comparable 2005 periods. Management believes the increase in surrenders is due to (i) the higher interest rate environment; (ii) recent acquisitions of blocks of annuity business; and (iii) policies coming out of their surrender charge periods.

In recent years, the Company's insurance subsidiaries have entered into several reinsurance transactions in connection with (i) the sale of GA-PR; (ii) the acquisition of Ceres and (iii) certain of its life and supplemental insurance operations. These transactions provided additional capital and liquidity and were entered into in the normal course of business in order to exit certain lines, fund acquisitions and transfer risk. The Company may enter into additional reinsurance transactions in the future.

GAFRI believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits, operating expenses, dividends and tax payments, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

#### Independent Ratings

The Company's principal insurance subsidiaries ("Insurance Companies") are rated by A.M. Best, Fitch and Standard & Poor's. Management believes that the ratings assigned by independent insurance rating agencies are important because agents, potential policyholders and school districts often use a company's rating as an initial screening device in considering annuity products. Management believes that (i) a rating in the "A" category by A.M. Best is necessary to successfully market tax-deferred annuities to public education employees and other not-for-profit groups; and (ii) a rating in the "A" category by at least one rating agency is necessary to successfully compete in other annuity markets. GAFRI's insurance entities also compete in markets other than the sale of tax-deferred annuities. Ratings are an important competitive factor; management believes that these entities can successfully compete in these markets with their respective ratings.

GAFRI's operations could be materially and adversely affected by ratings downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain lower ratios of debt to capital than it has in recent years and intends to maintain the capital of its significant insurance subsidiaries at levels currently indicated by the rating agencies as appropriate for the current ratings. Items that could adversely affect capital levels include (i) an extended period of low interest rates and a resulting significant narrowing of annuity "spread" (the difference between earnings received by the Company on its investments less the amount credited to policyholders' annuity accounts); (ii) investment impairments; (iii) a sustained decrease in the stock market; (iv) adverse mortality or morbidity; and (v) higher than planned dividends paid due to liquidity needs by GAFRI and AAG Holding.

Following are the Company's insurance ratings as of September 30, 2006:

	<u>A.M. Best</u>	<u>Fitch</u>	<u>Standard &amp; Poor's</u>
GALIC*	A (Excellent)	A+ (Strong)	A- (Strong)
AILIC	A (Excellent)	A+ (Strong)	A- (Strong)
Loyal	A (Excellent)	A+ (Strong)	Not rated
UTA	A- (Excellent)	Not rated	Not rated

\*GALIC is rated A3 (good financial security) by Moody's. Continental General and Central Reserve Life are rated "A" by Fitch.

GAFRI recently received a "positive" outlook from Moody's. All of the other ratings carry a "stable" outlook. In evaluating a company, independent rating agencies review such factors as the company's: (i) capital adequacy; (ii) profitability; (iii) leverage and liquidity; (iv) book of business; (v) quality and estimated market value of assets; (vi) adequacy of policy reserves; (vii) experience and competency of management; (viii) operating profile; and (ix) risk management.

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

At September 30, 2006, GAFRI's investment portfolio contained \$8.9 billion in "Fixed maturities" classified as available-for-sale, which are carried at fair value with unrealized gains and losses reported as a separate component of stockholders' equity on an after-tax basis. At September 30, 2006, GAFRI had pre-tax net unrealized gains of \$10 million on fixed maturities and net unrealized gains of \$8 million on equity securities.

GAFRI invests primarily in fixed income investments that, including loans and short-term investments, comprised 97% of its investment portfolio at September 30, 2006. GAFRI generally invests in securities having intermediate-term maturities with an objective of optimizing interest yields while maintaining an appropriate relationship of maturities between GAFRI's assets and expected liabilities.

The NAIC assigns quality ratings to publicly traded as well as privately placed securities. At September 30, 2006, approximately 94% of GAFRI's Insurance Companies' fixed maturity portfolio was comprised of investment grade bonds (NAIC rating of "1" or "2"). Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

At September 30, 2006, the mortgage-backed securities ("MBSs") portfolio represented approximately 30% of the Insurance Companies' investments. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of the lower current rates.

More than 95% of the Insurance Companies' MBSs are rated "AAA" with substantially all being investment grade quality. The market that these securities trade in is highly liquid. Aside from interest rate risk referred to above, GAFRI does not believe a material risk (relative to earnings or liquidity) is inherent in holding such investments.

Summarized information for the unrealized gains and losses recorded in GAFRI's balance sheet at September 30, 2006, is shown in the following table (dollars in millions). Approximately \$78 million of available-for-sale "Fixed Maturities" and \$8 million of "Equity Securities" had no unrealized gains or losses at September 30, 2006.

<u>Available-for-sale Fixed Maturities</u>	Securities with Unrealized Gains	Securities with Unrealized Losses
Fair value of securities	\$4,036	\$4,794
Amortized cost of securities	\$3,920	\$4,900
Gross unrealized gain (loss)	\$ 116	(\$ 106)
Fair value as % of amortized cost	103%	98%
Number of security positions	1,017	763
Number individually exceeding \$2 million gain or loss	1	-
Concentration of gains or (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 17.5	(\$ 49.9)
Banks, savings and credit institutions	14.8	(11.8)
Gas and electric services	13.8	(6.4)
Insurance companies	8.7	(6.3)
Percentage rated investment grade	92%	95%

Equity Securities

Fair value of securities	\$169	\$68
Cost of securities	\$150	\$79
Gross unrealized gain (loss)	\$ 19	(\$11)
Fair value as % of cost	113%	86%

26

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

The table below sets forth the scheduled maturities of GAFRI's available-for-sale fixed maturity securities at September 30, 2006, based on their fair values. Asset backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

<u>Maturity</u>	Securities with Unrealized Gains	Securities with Unrealized Losses
*	*	*
One year or less	4%	-%
After one year through five years	24	7
After five years through ten years	41	42
After ten years	<u>13</u>	<u>7</u>
	82	56
Mortgage-backed securities	<u>18</u>	<u>44</u>
	<u>100</u>	<u>100</u>
	%	%

\*Excludes \$78 million of fixed maturities with no unrealized gains or losses.

GAFRI realized aggregate losses of \$6.6 million during the first nine months of 2006 on \$149.1 million in sales of fixed maturity securities (five issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2005. These securities were "AAA" rated mortgage-backed securities that decreased in fair value by an aggregate of \$3.0 million from year-end 2005 to the sale date due to an increase in the general level of interest rates. None of the securities were sold out of a necessity to raise cash.

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Although GAFRI has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains.

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

	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
<u>Fixed Maturities at September 30, 2006</u>			
Securities with unrealized gains:			
Exceeding \$500,000 (39 issues)	\$ 419	\$ 33	108.5%
Less than \$500,000 (978 issues)	<u>3,617</u>	<u>83</u>	102.3%
	<u>\$4,036</u>	<u>\$116</u>	103.0%
Securities with unrealized losses:			
Exceeding \$500,000 (54 issues)	\$1,082	(\$ 41)	96.3%
Less than \$500,000 (709 issues)	<u>3,712</u>	<u>(65)</u>	98.3%
	<u>\$4,794</u>	<u>(\$106)</u>	97.8%
<u>Equity Securities at September 30, 2006</u>			
Securities with unrealized gains:			
Exceeding \$500,000 (14 issues)	\$118	\$ 15	114.6%
Less than \$500,000 (29 issues)	<u>51</u>	<u>4</u>	108.5%
	<u>\$169</u>	<u>\$ 19</u>	112.7%
Securities with unrealized losses:			
Exceeding \$500,000 (4 issues)	\$ 24	(\$ 9)	72.7%
	<u>44</u>	<u>(2)</u>	95.7%

Less than \$500,000 (16 issues)	)		
	\$ 68	(\$ 11)	86.1%

27

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q  
 Management's Discussion and Analysis  
of Financial Condition and Results of Operations - Continued

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

<u>Fixed Maturities with Unrealized Losses at September 30, 2006</u>	<u>Aggregate Fair Value</u>	<u>Aggregate Unrealized Gain(Loss)</u>	<u>Fair Value as % of Cost Basis</u>
Investment grade with losses for:			
One year or less (426 issues)	\$2,566	(\$ 32)	98.8%
Greater than one year (255 issues)	<u>1,985</u>	<u>(66)</u>	96.8%
	)		
	<u>\$4,551</u>	<u>(\$ 98)</u>	97.9%
Non-investment grade with losses for:			
One year or less (57 issues)	\$ 130	(\$ 5)	96.3%
Greater than one year (25 issues)	<u>113</u>	<u>(3)</u>	97.4%
	)		

<u>\$ 243</u>	<u>(\$ 8)</u>	96.8%
---------------	---------------	-------

## Equity Securities with Unrealized

Losses at September 30, 2006

One year or less (18 issues)	\$ 58	(\$ 10)	85.3%
Greater than one year (2 issues)	<u>10</u>	<u>(1)</u>	90.9%
		)	
	<u>\$ 68</u>	<u>(\$ 11)</u>	86.1%

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 GAFRI's 2005 Form 10-K.

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

## RESULTS OF OPERATIONS

General

As shown in Note E - "Segments of Operations", GAFRI reported pre-tax earnings from continuing operations of \$33.5 million for the third quarter of 2006 compared to \$16.4 million in the 2005 third quarter. Results from the 2005 quarter included a \$9.5 million pre-tax charge related to environmental liabilities at the Company's former manufacturing operations. Excluding this charge, pre-tax earnings from continuing operations increased \$7.6 million in the third quarter of 2006 over the same period in 2005. The increase primarily reflects (i) improved results in each of the Company's lines of business, including the results of acquisitions, and a \$3.4 million reduction of supplemental insurance IBNR reserves due to favorable claims development in the Medicare supplement business; and (ii) earnings on the proceeds received in connection with the sale of GA-PR.

Excluding the third quarter 2005 environmental charge, pre-tax earnings from continuing operations increased \$17.8 million in the first nine months of 2006 compared to the same period in 2005. This increase reflects (i) improvements in GAFRI's fixed annuity operations resulting primarily from the January 2006 acquisition of an annuity block of business and higher real estate income, (ii) higher earnings in GAFRI's runoff life operations resulting from an

28

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

improvement in mortality experience and lower expenses and (iii) earnings on the proceeds received in connection with the sale of GA-PR. These items more than offset a decrease in earnings in GAFRI's supplemental insurance operations in the first half of 2006. See "Life, Accident and Health Premiums and Benefits" below.

Statutory Annuity Premiums

The following table summarizes GAFRI's statutory annuity sales (in millions):

	Three months ended		Nine months ended	
	<u>September 30.</u>		<u>September 30.</u>	
<u>Annuity Premiums</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
403(b) Fixed and Indexed Annuities:				
First Year	\$ 14	\$ 10	\$ 39	\$ 29
Renewal	27	26	100	95
Single Sum	<u>86</u>	<u>23</u>	<u>158</u>	<u>57</u>
Subtotal	127	59	297	181
Non-403(b) Fixed Annuities	92	81	258	353
Non-403(b) Indexed Annuities	164	17	295	25
Variable Annuities	<u>19</u>	<u>22</u>	<u>67</u>	<u>70</u>
Total Annuity Premiums	<u>\$402</u>	<u>\$179</u>	<u>\$917</u>	<u>\$629</u>

Statutory annuity premiums in the third quarter of 2006 were more than double the premiums of the third quarter 2005. This increase primarily reflects substantially higher fixed indexed-annuity premiums; the Company re-entered this market in the second quarter of 2005.

Statutory annuity premiums in the first nine months of 2006 were 46% higher than the same 2005 period. Premiums in the first nine months of 2005 included approximately \$100 million of traditional fixed annuity premiums received in January 2005 from policyholders of an unaffiliated company in rehabilitation who chose to transfer their funds to GAFRI. Excluding the \$100 million, GAFRI's premiums in the first nine months of 2006 were 73% higher than the same period in 2005, also due primarily to higher fixed indexed-annuity sales as well as higher sales of traditional annuities in GAFRI's 403(b) segment.

Life, Accident and Health Premiums and Benefits



Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

The following table summarizes GAFRI's life, accident and health premiums and benefits as shown in the Consolidated Income Statement (in millions):

	Three months ended		Nine months ended	
	<u>September 30.</u>		<u>September 30.</u>	
<u>Premiums</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Supplemental insurance operations (1)				
First year	\$14	\$12	\$ 33	\$ 37
Renewal	70	52	185	155
Cincinnati life operations (in runoff)	<u>8</u>	<u>9</u>	<u>26</u>	<u>28</u>
	<u>\$92</u>	<u>\$73</u>	<u>\$244</u>	<u>\$220</u>
 <u>Benefits</u>				
Supplemental insurance operations	\$58 (2)	\$51	\$167	\$146
Cincinnati life operations (in runoff)	<u>11</u>	<u>11</u>	<u>33</u>	<u>36</u>
	<u>\$69</u>	<u>\$62</u>	<u>\$200</u>	<u>\$182</u>
 Ratio of Supplemental benefits to Supplemental premiums	69%(2)	80%	77%	76%

1. 2006 includes premiums from Ceres since its acquisition in August 2006.

2. Benefits in the third quarter reflect a \$3.4 million reduction of supplemental insurance IBNR reserves due to favorable claims development in the Medicare Supplement business.

GAFRI's supplemental insurance operations reflect lower first year premiums, higher lapses and higher loss experience in 2006. GAFRI expects the supplemental insurance loss ratio to decrease as a result of rate increases and the acquisition of Ceres. The acquisition broadens GAFRI's distribution in both the independent agent and captive agent channels. Prior to the Ceres acquisition, GAFRI's supplemental insurance products were sold through relatively few national marketing organizations.

29

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Premiums and benefits of GAFRI's Cincinnati Life operations reflect primarily traditional term and universal life insurance products. In 2004, GAFRI suspended new sales of these insurance products due to inadequate volume and returns.

### Net Investment Income

Net investment income increased \$12.8 million (9%) and \$32.7 million (8%) in the third quarter and first nine months of 2006, respectively, compared to the same periods in 2005 due primarily to an increase in average invested assets of approximately \$700 million (8%). Both years included approximately \$10 million in income primarily related to the early redemption of certain investments. The increase in assets reflects internal growth as well as acquisitions. See Note D - "Acquisitions".

The yield earned on GAFRI's investment portfolio, excluding real estate investments and realized gains, was approximately 6.0% for the nine months ended September 30, 2006 and September 30, 2005.

### Realized Gains (Losses)

#### Investments

Realized gains (losses) on investments included provisions for other than temporary impairment on securities still held as follows: third quarter of 2006 and 2005 - \$3.6 million and \$2.6 million; nine months of 2006 and 2005 - \$6.7 million and \$13.9 million, respectively.

#### Retirement of Debt

Loss on retirement of debt reflects pre-tax losses on repurchases of \$66.4 million principal amount of the Company's 6-7/8% Senior Notes for \$68.7 million in cash. In addition, in connection with the repurchase, GAFRI paid \$2.0 million to effectively terminate the portion of an interest rate swap that covered the repurchased debt; this amount is included in loss on retirement of debt in the Consolidated Income Statement.

### Other Income

Other income increased \$10.9 million (50%) and \$15.4 million (24%) in the third quarter and first nine months of 2006 compared to the same periods in 2005. The increases reflect higher administrative cost reimbursements received from reinsurers (resulting from the acquisition of Ceres) and higher income on GAFRI's continuing real estate operations (see below). The first nine months of 2006 also includes a payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company.

### Real Estate Operations - Continuing

GAFRI is engaged in a variety of real estate operations including hotels and marinas. Revenues and expenses of these operations are included in GAFRI's Consolidated Income Statement as shown below (in millions).

	<u>Three months ended</u>		<u>Nine months ended</u>	
	<u>September 30.</u>		<u>September 30.</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Other income	\$9.7	\$7.2	\$27.4(1)	\$20.3
Other expenses:				

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Operating expenses	7.0	5.4	17.0	13.9
Depreciation	0.9	0.8	2.5	2.1
Other	0.6	0.4	1.0	2.2

(1) Includes \$4.9 million of income resulting from a March 2006 payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company.

Real Estate Operations - Discontinued

On June 2, 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for a price of \$166 million. After sales expenses, contingencies and the write-off of certain deferred acquisition costs on annuities associated with the gain recognition, the Company recognized a pre-tax gain of approximately \$48.7 million (\$31.6 million after-tax, or \$0.66 per diluted share). The Company had owned and operated the hotel since 1993. The operating results

30

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

and gain on the sale of Chatham have been included in discontinued operations in the Consolidated Income Statement.

Also included in discontinued hotel operations in the Consolidated Income Statement are the results of the Driskill Hotel, which was sold in October 2005. See Note C - "Discontinued Operations" for revenues and expenses of Chatham Bars Inn and the Driskill Hotel.

Annuity Benefits

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

Annuity benefits increased \$7.3 million (9%) and \$10.5 million (4%) in the third quarter and first nine months of 2006, respectively, compared to the same periods in 2005. This increase reflects higher annuity reserves due to internal growth and the acquisition of \$280 million of reserves in January 2006, partially offset by lower average effective crediting rates.

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

Insurance Acquisition Expenses

## Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-Q

Insurance acquisition expenses include amortization of DPAC as well as a portion of commissions on sales of insurance products. Insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired. The increase in insurance acquisition expenses in 2006 reflects the growth in the Company's business as well as the acquisition of a block of annuities in January 2006 and the acquisition of Ceres in August 2006.

The vast majority of GAFRI's DPAC asset relates to its fixed annuity, variable annuity and life insurance lines of business. Unanticipated spread compression, decreases in the stock market, and adverse mortality experience could lead to write-offs of DPAC in the future.

### Interest and Debt Expenses

The decrease in interest and debt expenses in the third quarter and first nine months of 2006 compared to the same periods in 2005 reflects the Company's repurchases of debt. In the fourth quarter of 2005, GAFRI repurchased \$20.8 million principal amount of its 8-7/8% preferred securities; in the first nine months of 2006, GAFRI repurchased \$66.4 million of the Company's 6-7/8% Senior Notes. The effect of these repurchases was partially offset by a higher effective interest rate on the Company's floating rate debt.

### Other Expenses

Other expenses increased \$1.1 million (3%) and \$3.9 million (4%) in the third quarter and first nine months of 2006, respectively, compared to the same periods in 2005. The increase reflects the acquisitions in 2006, higher real estate expenses, and higher expenses in the Company's supplemental lines of business. The third quarter of 2005 also includes a \$9.5 million environmental charge related to the Company's former manufacturing operations.

### Income Taxes

The effective tax rate on GAFRI's continuing operations approximated 34%-35% in the third quarter and first nine months of 2006 and 2005.

31

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

### of Financial Condition and Results of Operations - Continued

### Recent Accounting Standard

#### Income Taxes

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" ("FIN 48"), which is effective for fiscal years beginning after December 15, 2006. 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. Management is currently evaluating the impact of adopting this interpretation.

Item 3

Quantitative and Qualitative Disclosure of Market Risk

As of September 30, 2006, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure about Market Risk" in GAFRI's 2005 Form 10-K.

Item 4

Controls and Procedures

GAFRI's management, with participation from its Chief Executive Officer and Chief Financial Officer, has evaluated GAFRI's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of September 30, 2006. Based on that evaluation, GAFRI's CEO and CFO concluded that these disclosure controls were effective.

During the third quarter of 2006, a modification was made to the controls of one of GAFRI's systems to prevent duplicate claim payments. Other than this, there have been no changes in GAFRI's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, GAFRI's internal controls over financial reporting.

On August 7, 2006, we completed our acquisition of Ceres Group, Inc. As a result, the Ceres operations have been excluded from our review of internal controls under Section 404 of the Sarbanes-Oxley Act of 2002. The acquisition of Ceres had a material impact on internal control over financial reporting. We are now in the process of integrating Ceres' operations including internal controls and processes and extending our Section 404 compliance program to the Ceres operations. See Note D to the Consolidated Financial Statements included in Item 1 for discussion of the acquisition and related financial data.

GAFRI management intends to continually review and evaluate the design and effectiveness of our disclosure controls and procedures and to improve controls and procedures over time and to correct any deficiencies that may be discovered in the future.

32

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

PART II

OTHER INFORMATION

Item 2

Unregistered Sales of Equity Securities and Use of Proceeds

GAFRI made the following purchases of its \$1 par value common stock during the third quarter:

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs(a)</u>
<u>3rd Quarter 2006</u>				
July	-	-	-	-
August	7,400	19.76	7,400	1,538,674
September	-	-	-	-

(a) Represents the remaining shares that may be repurchased under the Plan authorized by GAFRI's Board of Directors in 2005.

Under GAFRI's stockholder-approved Stock Option Plan, 22,475 shares of GAFRI Common Stock were tendered in connection with the exercise of stock options for a total of 29,396 shares in the third quarter of 2006 (all at an average market price of \$19.99 in July; none in August; and none in September).

Item 6

Exhibits

Exhibits:

<u>Number</u>	<u>Exhibit Description</u>
31(a)	Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.

- 31(b) Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 32 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 USC Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned duly authorized.

GREAT AMERICAN FINANCIAL RESOURCES, INC.

November 8, 2006

BY:/s/Christopher P. Miliano

Christopher P. Miliano  
Chief Financial Officer

33

GREAT AMERICAN FINANCIAL RESOURCES, INC.

EXHIBIT 31(a)

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

I, S. Craig Lindner, the principal executive officer of Great American Financial Resources, Inc., certify that

1. I have reviewed this quarterly report on Form 10-Q of Great American Financial Resources, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
  
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
  
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the



registrant's ability to record, process, summarize and report financial information; and

- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2006

/s/ S. Craig Lindner

S. Craig Lindner

Chief Executive Officer

E-1

GREAT AMERICAN FINANCIAL RESOURCES, INC.

EXHIBIT 31(b)

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS - CONTINUED

I, Christopher P. Miliano, the principal financial officer of Great American Financial Resources, Inc., certify that

1. I have reviewed this quarterly report on Form 10-Q of Great American Financial Resources, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2006

/s/ Christopher P. Miliano

Christopher P. Miliano

Chief Financial Officer

GREAT AMERICAN FINANCIAL RESOURCES, INC.

EXHIBIT 32

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER

Pursuant to 18 USC 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 Great American Financial Resources, Inc. (the "Company") on Form 10-Q for the period ended September 30, 2006 (the "Report"), the undersigned officers of the Company, certify, pursuant to Section 18 USC 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 Exchange 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.

/s/ S. Craig Lindner

S. Craig Lindner

Chief Executive Officer

/s/ Christopher P. Miliano

Christopher P. Miliano

Chief Financial Officer

November 8, 2006

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

E-3